THE PROPERTY TAX AND LOCAL AUTONOMY

EDITED BY
Michael E. Bell, David Brunori, and Joan Youngman

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LINCOLN INSTITUTE
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Foreword

In the first volume of the Lincoln–George Washington Institute of Public Policy Roundtable series, *Erosion of the Property Tax Base,* we documented trends and causes of the local property tax base decline. In this volume, we focus attention on the "so what" question: Why is it important that local governments have access to a strong, vibrant local property tax?

The answer to this question is rooted in the concept of *local autonomy.* The American political landscape is dominated by the belief that localities are critical to governance. Local autonomy—the ability of local government to undertake activity that reflects the preferences of local residents—requires a source of locally raised revenue that local government can use as it sees fit. Local autonomy is the underlying premise of the efficiency gains presumably derived from the theory of fiscal federalism (see Oates, chapter 2 of this volume). It also stimulates civic engagement and is the basis of local democracy and accountability.

The local property tax has been the primary source of local own-source revenue that local autonomy depends upon. In this volume, we consider the consequences for local autonomy that flow from a decline in the local property tax base. The chapters include arguments in support of (and against) local autonomy and decentralization, efforts to measure local autonomy and its variations among the 50 states, research on the effect of school finance reform on the local tax base and on support for elementary and secondary education, the consequences of reduced property tax on local autonomy, and possible replacements for the property tax as a means of financing autonomous local governments.

This book and the 2009 conference at which these chapters were initially presented as papers are part of an ongoing collaboration between the Lincoln Institute of Land Policy and the George Washington Institute of Public Policy to advance understanding of the property tax and to strengthen policy recommendations for its improvement. A major part of this effort involves gathering and disseminating data on the operation of the property tax. In June 2009, the two organizations set up a public Web site, *Significant Features of the Property Tax,* devoted to providing a wide range of data on the local property tax in the 50 states. The publication, which can be accessed at http://lincolninst.edu/subcenters/significant-features-property-tax/ will be updated annually. Publications such as this book use these data to analyze how the tax functions and to draw scholarly attention to its policy challenges.

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

Harold Wolman
Director
George Washington Institute of Public Policy
The George Washington University

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Property Taxes and Local Autonomy

An Overview

DAVID BRUNORI AND MICHAEL E. BELL

In 2007, the Lincoln Institute of Land Policy and the George Washington Institute of Public Policy (GWIPP) sponsored a property tax policy roundtable that documented the decline of the real property tax base, with particular emphasis on trends and causes. The conclusions were stark: the long-term trends indicated significant declines in the property tax base. The property tax is seen as being under siege as a result of a myriad of rate and assessment limitations, extensive residential relief programs, aggressive economic development incentives, and almost universal public unhappiness (Augustine et al. 2009). The 2007 roundtable resulted in a volume entitled *Erosion of the Property Tax*.

That research inevitably led to the question, why does a declining property tax base matter? The trends documented in that first volume have led to a continued assault on the property tax as the mainstay of local own-source revenues. In this context, Brunori (2007, 4) argues that "without fiscal autonomy, local governments are almost irrelevant in the American federal system of government." The Lincoln Institute of Land Policy, once again in collaboration with GWIPP, sponsored a second property tax policy roundtable in February 2009, called Property Tax and Local Autonomy, to explore further property tax trends in the 50 state and local fiscal systems in the United States as well as the implications of those trends for local autonomy. The Lincoln Institute and GWIPP commissioned a set of research papers from leading scholars and public finance experts to delve into specific aspects of why a declining property tax base matters. The contributors were asked to discuss why it is important that local governments have access to a strong, viable, and vibrant property tax.

The chapters in this book represent the research and discussions presented at the 2009 roundtable. The underlying theme is that localities are critical to the governance of the United States. That is, localism is a normative good. As Bird (1993) asserts, "so long as there are variations in tastes and costs, there are clearly efficiency gains from carrying out public sector activities in as decentralized fashion as possible." And the ability to raise revenue has long been heralded as the key to maintaining strong local governments.

In addition, Thomas Jefferson was a strong advocate for local government as the best protection of individual liberty. Since the property tax is the mainstay of local finances, the erosion of the property tax raises serious questions about the future health of our federal system of government and the ability of local governments to continue to protect what Tocqueville called America's passion for popular sovereignty.

This situation is exacerbated because local and state governments have experienced what could be called the *politics of antitaxation*. Since the late 1970s there has been a concerted effort to politicize, even demonize, taxation. This often fervent antitax sentiment has festered at all levels of government during the past quarter century. Antitax politics fueled the passage of Proposition 13 in California and spurred property tax revolts around the country. Tax cutting became a regular theme for gubernatorial and legislative candidates seeking election in virtually every state. The politics of antitaxation have limited local governments' ability to raise revenue precisely when the demand for services and education spending has increased. Because the property tax has been the primary source of revenue for local governments since the beginning of the republic, the chapters presented in this volume examine the issues and consequences of a declining property tax base. Brunori (2007) and others argue that property taxes are essential to local autonomy largely because there are no viable alternatives for raising revenue. Thus the question of what happens to local autonomy in an era of declining property tax bases is critical.

In chapter 2, Wallace Oates, one of the most noted scholars in the field, explores the economic foundation for the important role of local government. He acknowledges the role of local government in promoting the expansion of popular democracy, which is a familiar theme. A system of local government can encourage the direct participation of a broad segment of the citizenry in public decision making. For example, John Stuart Mill extolled the importance of local government for "the public education of the citizens" through providing a wider opportunity for direct participation in public affairs. The traditional concern of the economist, in contrast, is with the efficient and equitable allocation of resources. From this perspective, the economic contribution of local government is found in its capacity to enhance the effectiveness of resource allocation within the public sector as a whole.

In this context, Oates argues that one of the appealing features of property taxation in the United States is that it is almost exclusively a local tax. It is not used to any significant extent by states or by the federal government; it belongs to local government. As such, reliance on local property taxation contributes to local autonomy and transparency. People understand that their property tax payments support the provision of local public services; they provide a link between the benefits and costs of local services that encourages efficient fiscal decisions. There is much to be said, in Oates's view, for some degree of "separation of sources" in taxation. The fact that local governments (in practice at least) have pretty much exclusive rights to the use of their property tax contributes to its effectiveness as a local tax and to its role in promoting local autonomy.

Oates concludes that from a purely economic perspective, the basic role of local government is to enhance the performance of the overall public sector by allowing variation in the outputs of local services in accordance with differing local tastes and costs. In addition to this contribution to the "static" efficiency of the government sector, local finance can encourage innovation in public policy. Within a system of local governments, there is the opportunity for wide-ranging experimentation with new approaches to solving problems in local government finance. However, Oates recognizes that there are some challenging and subtle equity issues that arise in the context of local government finance. One local service in particular seems central to this objective: public education. In this context, there is an argument for some form of assistance for underfunded schools (largely in low-income areas). That inequities exist, however, is neither an indictment of the property tax nor an argument for management of schools at a higher level of government.

William Fischel explores issues of school finance in more depth in chapter 3. For most of American history, elementary and secondary education was the responsibility of local governments. And the local property tax was the dominant—indeed almost sole—source of funding for K–12 education. That central role began to change during the 1970s and 1980s with the advent of increased state financing of education. The increased involvement of the states was due in large part to education finance litigation and property tax revolts. Over the past several decades state governments have taken an increasingly large role in financing elementary and secondary education.

Fischel takes on the relationship between school finances and the property tax in his chapter. He applies the median voter model to school district finances. He argues five points. First, voters are collectively "smarter" than individual voters, and local decisions are thus economically rational. Second, local tax prices—as opposed to tax rates—are reasonably efficient budget constraints. Third, poor people are better served by state-level policies than by wealth-based property taxes. Fourth, local property taxes are preferable to local income taxes. And fifth, state-level financing will displace local decision making and result in policies less desirable to the majority. Fischel concludes that property taxation—as opposed to local income taxation—is a fairly sensible way of funding local schools because it reduces local tax prices without driving away the tax base. In the remainder of his chapter, Fischel assesses the implications of the increasing role of state government in financing education and the importance of teacher unions in displacing local voters from control of the schools. Fischel hypothesized that teacher unions would have more impact on state decision making, thus diluting citizen control. He concludes, however, that teacher unions have not had sufficient impact to eliminate the median voter from the process.

Chapters 4 and 5 involve discussions of local autonomy and fiscal centralization across the 50 state and local systems in the United States, two related yet distinct concepts. In chapter 4, Harold Wolman, Robert McManmon, Michael E. Bell, and David Brunori develop a novel and intriguing index to measure local government autonomy in the United States. Over time, scholars have developed different definitions of the term *local autonomy*. The inconsistent treatment of the concept in public policy research and popular debates has created ambiguity over the meaning—making it highly difficult for social scientists to empirically compare work on the topic. If, in fact, the declining property tax base has an effect on the local autonomy, Wolman et al. believe a new and precise definition of the term must be developed and utilized. Drawing from Wolman's (2008) conceptual framework for classification of local government systems, the chapter authors define "local autonomy" as a system of local governments in which local governments (1) have an important impact on their larger economy and intergovernmental system; (2) have the discretion to engage in fiscal, functional, and organizational activities without restraints from higher levels of government; and (3) have the capacity or means to achieve their policy and governance preferences.

Wolman et al. use factor analysis and a local government autonomy index derived from it to empirically compare the state systems of local government autonomy. Their measures are different and, arguably, more useful than existing studies for explaining variance in local government autonomy because these measures reflect our conception of local autonomy as multidimensional. The 20 variables presented in this chapter capture many of the differences in state and local government systems across three dimensions of local autonomy. Wolman et al. then use their index of local autonomy to explore whether local governments in states with greater local autonomy—presumably permitting a greater degree of conformance to the preferences of the local citizenry—raise and spend more or less money per capita than do those with less local autonomy. The empirical results suggest that their local autonomy index is significantly related to variations in expenditures per capita across states, but it is not related to variations in property taxes per capita across states. The authors acknowledge that their overall local government autonomy index is not perfect. However, the index is a useful tool for understanding the relative rankings and differences among states for dimensions of local autonomy, and it captures more aspects of autonomy than existing rankings do. Finally, their results suggest that the degree of local autonomy has a real impact on some important local fiscal outcomes.

In chapter 5, Katrina D. Connolly, David Brunori, and Michael E. Bell discuss whether state and local finances are becoming more or less decentralized. The authors also discuss why policy makers should care one way or another. They argue that in the wake of the tax revolt launched by Proposition 13 in California in 1978, the issue of fiscal centralization has become increasingly important. Specifically, they argue that local tax revolts undermine local autonomy, because they cause property tax limits to be placed on the local government's main source of revenue, while the demand for services will stay the same, which then pressures the state to "buy" local services and increase state authority over those services. Connolly et al. explore the various definitions of centralization and decentralization in the literature and the various ways the concepts have been measured. They then review the literature on fiscal centralization and decentralization and conclude that authors examining various periods of the twentieth century agree on the existence of the trend of state fiscal centralization. The consistent findings provide strong evidence for the trend of state fiscal centralization.

Chapter 5 suggests that local governments are becoming more dependent on state revenues, in large part because of education finance reform efforts in a number of states that result in state revenues being substituted for local property taxes. The authors point out that many researchers argue that the proliferation of various types of tax and expenditure limits also restrict the flexibility of local governments in raising revenues, thereby further eroding their autonomy. The authors' research documents a strong relationship between the share of state and local own-source revenues raised by local governments and the degree of local autonomy—the larger the share, the stronger is local autonomy.

Given the trend toward centralization, future research should concentrate on the policy and political outcomes of increased centralization. To date, much of the work has been done in the area of K–12 education. That is, researchers have looked at the effects of state centralization on the public school systems that were traditionally operated and financed locally. Other policy areas, such as public safety and transportation, are ripe for similar study. If fiscal responsibilities are shifting to the states, policy makers and the public should know if those shifts will affect other public service areas. Such research is necessary to assess the effects on centralism on our core belief that localism is the key to efficiency and democracy.

Despite almost universal endorsement by public finance experts, the property tax remains politically unpopular. Every year there are calls to further curtail or even repeal property taxes. Chapters 6 and 7 explore some of the political animosity toward the tax. In chapter 6, Ronald C. Fisher, Andrew Bristle, and Anupama Prasad provide an overview of the implications of eliminating the property tax. They seek to ascertain meaning in the recent debates over the elimination of the property tax. Specifically, they review recent attempts in Texas, Georgia, Indiana, and Florida to either eliminate the property tax or reduce it to a state of irrelevancy. They also review older efforts at property tax limits in California and Michigan.

Fisher et al. find three key policy issues to be the crux of the debate about recent property tax reduction and elimination proposals: (1) the unhappiness created by the growth of property taxes, especially related to growth in housing values for homeowners; (2) the role for local governments, particularly the value of fiscally independent local governments as opposed to state government revenue collection or state government provision of all services; and (3) the characteristics or relative advantages of alternative revenue sources compared to the property tax, including significant distributional differences. They find that a common theme in most states considering major property tax reduction is the growth rate of the tax, especially for homeowners. Taxes can grow substantially from changes in tax rates, taxable values, or both. A number of states have set maximum tax rates (as a percentage of value). But if the market and taxable values of properties in a jurisdiction rise and the tax rate is kept constant (or even if the tax rate is reduced, but less than proportionally to the increase in values), then property tax amounts for those properties that are increasing in value will also increase.

The fact that the increased wealth is not realized until the asset is sold has sometimes led to the charge that taxpayers face higher property taxes without additional money income to pay the higher tax amount. Although traditionally thought of as a problem especially for senior citizens, this issue may also be problematic for individuals who purchased homes based on the maximum monthly payment that the household could afford and then see values increase. Fisher et al. note that in each of the six states considered, reduction of the property tax has been associated with an increased state role through intergovernmental grants for public K–12 education. This was a large part of the underlying rationale for the changes in California and Michigan, was adopted recently in Indiana and Texas, and is the essence of the latest proposals in Florida and Georgia. However, if property tax reduction is to be extended beyond school property taxes, or even to the point of full elimination, then states must explore expansion of revenue sharing or grants to general-purpose government (or a redefinition of state as opposed to local government roles). Such an expansion or change in government structure is likely to be more difficult than merely increasing state aid to schools.

In chapter 7, Richard F. Dye asks what the future property tax will look like. Despite its contentious history, according to Dye, the property tax will ultimately prevail in the policy debate over financing localities, and local governments will continue to play an important role with respect to public safety, transportation, and education. Dye asserts that the property tax is the only viable source of revenue because an aging U.S. population will prevent the substitution of increased intergovernmental aid or alternative own-source revenue, a unique perspective. Therefore, states are unlikely to increase aid to localities in the future because they will be faced with increased costs for medical services and pensions. Similarly, states will be restrained from raising significant amounts of additional revenue by those same demographic phenomena. An aging population will result in less income and lower sales tax collections. Given both the spending and revenue-raising pressures, Dye concludes that the property tax will not only survive but also prosper well into the future.

In the final chapter, Michael A. Pagano and Christopher W. Hoene introduce a new concept into the field of local government finance—*fiscal policy space.* Building upon previous work on fiscal capacity, the authors seek to capture the unique financial situations of individual cities to illustrate more realistically the environment in which municipal policy officials operate. The authors want to move the discussion from policy prescription that assumes that city officials do not matter to a construct that recognizes how city officials actually operate, decide, and create fiscal policy.

Pagano and Hoene regard fiscal policy space as a structured set of internal arrangements of elements and the linkages and intersections among those elements that define the character of the space itself. They define fiscal policy space as a set of five attributes that limit, shape, or provide opportunities for policy choices to be made by municipal policy officials. Fiscal decision making occurs within the constraints of the "fiscal policy space" of a particular city. Consequently, the architecture of the fiscal policy space comprises the five fiscal policy attributes that shape, bind, or provide new fiscal policy choices for local decision makers. According to Pagano and Hoene, these five attributes structure and frame the fiscal policy space of local government officials, expanding the size of this space for some communities and reducing it for others, as follows: (1) state or intergovernmental context; (2) economic base of the municipality; (3) locally imposed fiscal controls; (4) service responsibilities; and (5) political culture. The authors argue that understanding the full set of constraints and opportunities faced by city government decision makers will help to better inform us about the fiscal health and fiscal performance of American cities.

In summary, the contributing authors in this book explore the issues presented by a declining property tax base. The philosophical, economic, and political rationales for a strong property tax are clear. The property tax is the most efficient and effective means for raising revenue to fund local government services. No other sources of revenue can ensure local government autonomy. And such autonomy has been a critical factor in American government since the beginning of the republic. The chapters all reflect the position that the property tax is a normative good. It remains the most sensible way of financing local services, including elementary and secondary education (until recent years a decidedly local government function). Yet the political pressures on the property tax proceed unabated. As the chapters illustrate, reduced reliance on the property tax has led to more centralization (particularly with respect to education financing) and less local autonomy.

Understanding the consequences of a diminished property tax system is critical to setting state and local policy in the twenty-first century. If, in fact, the property tax continues to play a reduced role, local governments will be forced to rely even more heavily on state political institutions. If that happens, the overall system will likely be less efficient and less politically responsive. Still, the theoretical underpinnings of the property tax remain strong. As Dye has astutely observed, the property tax will likely thrive in the future. There are, after all, no other viable options.

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