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The Hardest Challenge to Value-Based Taxes, Part II
Measures to Address Volatility That Do Not Preserve Uniformity

The previous article in this series¹ considered methods of countering one of property taxpayers' most powerful fears: rapidly escalating values that send tax bills beyond their ability to pay. The "nightmare scenario" that can erode all support for the property tax pictures long-term residents, particularly the elderly, losing their homes because skyrocketing property tax bills reflect housing price inflation but bear no relation to the taxpayers' modest or even fixed incomes. This concern is a staple of local reporting around the nation.

From the suburbs of Boston:

In Milton, "house poor" widows on limited incomes struggle to keep up with property taxes, water bills, and homeowners insurance. Sometimes, they skimp on medicine or food to pay their bills. In Plymouth, the town treasurer is constantly dealing with tax delinquents, many of whom are elderly. The law leaves him little choice but to proceed toward foreclosure. In Whitman, retired shoe workers on pensions as small as \$35 a month helplessly watch rising property taxes."²

From Charleston and its surrounding beaches communities:

[R]ising values and rising taxes can make it even more difficult to hang on to homes that have been in the family for decades, if not generations. That severs social continuity in neighborhoods and changes the feel, as more outsiders and part-time property owners move in... [A] lawyer who lives on King Street said he knows of instances where families might have to move out of their downtown homes if their taxes rise much more....³

In Austin:

Pauline Johnston, widowed since 1972 and living on about \$800 a month in Social Security, pension and investment income, was stunned to see the appraisal on her four aging

¹"The Hardest Challenge for Value-Based Property Taxes: Part I," *State Tax Notes*, March 8, 1999, p. 745.

²Sue Scheible, "No Relief Seen in Elderly Plan," *Quincy Patriot Ledger*, August 26, 1998, p. 1.

³Robert Behre, "The Reassessment Riddle," *The Charleston Post and Courier*, August 9, 1998, p. A1.

properties jump \$95,600 this year. Her taxes, which she pays in a lump sum each December or January, probably will increase almost \$1,600.⁴

In Minneapolis:

Under the current Minnesota market value system, taxable market values can be driven up by “market forces” over which homeowners have absolutely no control. If, for example, someone moves into your neighborhood and pays much more for a home or lot than it's worth - or builds a much more luxurious home than the average in the neighborhood - the following year your taxable market value (and taxes) will go up significantly - yet you haven't done a thing to increase its value. It's the same home it was before, but more importantly, no one has given you more money with which to pay the resulting increase in your property taxes!⁵

This being practically and politically an unacceptable outcome, how should the property tax system be adjusted to avoid it? The previous article dealt with ways of preventing this outcome that do not affect the tax rate or the method of valuation. When taxpayer discontent reaches the proportions of a political crisis, however, such measures are rarely dramatic or immediate enough to be deemed sufficient. The most frequent responses either differentiate among property classes or freeze property tax bills.

Classification.

Because the nightmare scenario involves individual residences, one obvious solution distinguishes between the tax treatment of residential and business property. This response is so obvious, in fact, that even where state law does not permit such classification, “extra-legal” or even plainly illegal classification has often been achieved through disproportional valuation and assessment practices. Elected officials know that voters are keenly aware of residential tax burdens; business property taxes are often considered “victimless” taxes – falling on rich corporations, exported outside the jurisdiction, or disappearing into the ether.

This approach does involve costs. Diminishing the neutrality of the tax exacts a price in efficiency: if changes in land use produce large changes in the property tax, the tax will influence economic decision-making. Shifting the tax to business property may reduce the jurisdiction's economic competitiveness. Attempts to reduce this effect through tax reductions and incentives to specific businesses compounds the loss of uniformity and

⁴Ben Wear & Jeff South, “Travis County Home Values Rise,” *Austin American-Statesman*, May 28, 1998, p. A1.

⁵Richard G. Wray, “Increase in Home's Market Value Shouldn't Drive Up Your Tax Bill,” *Minneapolis Star Tribune*, March 24, 1997, p. 13A.

simplicity. Moreover, the same visibility that makes the property tax a ready target of discontent also plays a crucial role in promoting accountability and transparency in local government. Exporting or shifting the tax eliminates this important benefit.

These problems are compounded by inherent pressure towards ever greater complexity in the classification process itself. A simple division between residential and non-residential property rarely ends the political impetus for special distinctions. Agricultural property has its own assessment provisions in each state; open space and forest land may be subject to different treatment. Business property may consist of commercial, industrial, or utility property; residential property includes primary residences, second homes, vacation homes, multi-family property, condominiums, and cooperatives, all of which have special tax provisions in specific states. Special treatment of homestead property constitutes another form of classification. Minnesota now has as many as forty to sixty or more classes (the exact number differing according to definition, and whether the state's progressive rate structure is itself considered a form of classification).⁶ The cost in terms of clarity, simplicity, and uniformity is obvious - yet the state has still experienced a shift in the property tax burden from businesses to homeowners.⁷

How well does classification address the nightmare scenario? Certainly lowering residential rates reduces the threat that homeowners will be unable to pay their tax bills, although it achieves this by reducing the bills of the needy and the non-needy alike. By contrast, circuit-breaker legislation seeks to address income pressure directly – not by affecting property assessment, but by reducing the ultimate burden on the taxpayer.⁸ Classification may even be too uniform an instrument to address the nightmare scenario when unexpected price inflation affects property in one currently desirable location and not in other parts of the jurisdiction.

Property Tax Freezes.

The most direct method of counteracting tax volatility is to break the connection between price levels and assessments, basing taxes on another, non-changing measure rather than on market value. This is the model of California's Proposition 13, which basically substitutes purchase price for market value as the tax base, allowing no more than a 2 percent annual inflation adjustment. Of course, volatility could be eliminated by basing the tax on a measure entirely unrelated to market values. In the non-market economies of the Soviet era, land and building taxes were commonly denominated in units of currency per square meter or hectare of property area, with no expected relationship between the tax due and any price level.

⁶John A. Murray and Jeffery J. McNaught, "Minnesota Property Tax," American Bar Association, *Property Tax Deskbook*, 3rd ed., 1997-1998, at p. 24-9.

⁷Michael P. Ettlinger, Tyson Slocum, and Robert G. Lynch, "Tax Strategies for a Strong Minnesota," *State Tax Notes*, August 3, 1998, p. 289, at 297-298.

⁸For a discussion of circuit breakers, see Scott Mackey and Karen Carter, "State Tax Policy and Senior Citizens," *State Tax Notes*, April 3, 1995, p. 1405.

The concept of a “freeze” suggests something different: a temporary suspension of market-value assessments, which will be resumed at some later point. In the case of California property, a new owner generally faces a new market-value assessment. When senior citizens’ property taxes are frozen, those preferential assessments are personal to the owner and will not benefit younger purchasers. When taxes in an entire jurisdiction are frozen, it is anticipated that this suspension of normal procedure will provide time in which the “broken” system can be repaired and a new approach developed. A freeze is not generally presented as a permanent solution.

Experience suggests caution in this regard: once a freeze is imposed, the process of thawing may be too painful to bear. A temporary freeze may extend to new classes of owners, new types of property, and new periods of ownership. California now makes a home’s acquisition value portable in many cases. Some senior citizens and disabled persons may transfer their acquisition value from one residence to another, or even from one county to another. Parents may bequeath their home’s acquisition value to their children, or their orphaned grandchildren, along with their residences. Thus the freeze extends across parcels, across county lines, and even across generations. Nor will new construction necessarily add to the acquisition value - not if undertaken for purposes of seismic safety, historic preservation, post-disaster reconstruction, solar energy, fire prevention, or replacement for a taking in eminent domain.⁹

Texas presents a similar situation. There, the state constitution freezes school property taxes for senior citizens. As with Proposition 13, this was not thought to require a corresponding reduction in taxes upon a new residence, so long as the new taxes were themselves stable and predictable. The impetus to protect the cash-poor long-term homeowner did not imply any obligation to protect the new owner who could afford to purchase at current prices.

Yet once taxes were frozen for senior citizens, the prospect of moving to full assessment upon a new residence – an assessment that would not rise with rising market values – was entirely unwelcome even to those with the funds to buy a larger property. In arguing to change the law, one state senator cited the case of a senior citizen whose school taxes rose from \$212 to \$1740 because of a move to a new residence.¹⁰ In response, a new amendment permitted a senior homeowner’s frozen assessment to be transferred on a pro-rata basis to a new home. Thus the frozen assessment on a \$50,000 home would constitute half the taxes on a new \$100,000 residence. Texas then extended its freeze once again, to permit this proportional transfer to be retroactive for up to five years in specified counties.

Note that this situation contradicts many elements of the nightmare scenario. That involves a long-term homeowner whose cash income has not kept pace with rising property values, who faces the loss of a residence for failure to meet unpredictable and uncontrollable tax bills. Concern has now shifted to a homeowner who is not left behind

⁹See generally Kenneth A. Ehrman and Sean Flavin, *Taxing California Property*, (3rd ed. 1988, and loose-leaf supplements).

¹⁰Chris Harris “Amendment 1: Good for Texas Taxpayers,” *The Fort Worth Star-Telegram*, August 2, 1997, p. 13.

by rising property values, who in fact is able to trade up to a more expensive residence but faces an increase in property taxes upon doing so. The extension of the freeze does not seek to avoid the unacceptable consequences of the nightmare scenario but to avoid the painful “thaw” when the freeze is lifted. The freeze itself has become the justification for its own extension, an extension that will leave the property tax less uniform and more readily attacked as unfair, complex, and arbitrary.

A second cautionary note concerns the efficiency and equity implications of breaking the connection between assessments and market value. With regard to the land component of the property tax, a tax on value that is not affected by the owner’s actions does not distort the economic process. It does not cause changes in supply and demand in response to the tax. A measure such as Proposition 13 produces huge tax consequences as a result of changes in ownership. The dissenting opinion to Supreme Court decision upholding the constitutionality of Proposition 13 cited ten-fold and even hundred-fold discrepancies in the assessed values of similar property, depending upon its date of purchase and acquisition value.¹¹ *The New York Times* found that the taxpayer challenging Proposition 13, who paid taxes on her 1988 acquisition value of \$170,000, occupied property comparable to neighbors whose 1975 tax value, essentially frozen since that time, was \$32,000.¹² These owners would certainly take the tax consequences into account before moving to a new residence for which the acquisition value would be at full market levels. Even more dramatically, the prospect of inheriting an acquisition value along with a home would clearly encourage the younger generation to occupy their parents’ property rather than sell it and use the proceeds to move to another, possibly more appropriate, residence. By offering a tremendous financial incentive to maintain an existing residence, the law affects the economic choices of property owners throughout the state.

The equity implications are simply another aspect of these discrepancies in assessments between owners of similar properties. One original justification was the equity of forewarning: anyone who could afford the current price and had full knowledge of the future tax that would accompany it had no complaint on grounds of equity. The extension to new purchases discussed above raises some question as to the adequacy of that rationale. Another justification may be the self-limiting nature of such distortions – all property held by individuals by definition changing hands at least once a generation. Leaving aside the problem of equity in the taxation of business property, the provisions permitting inheritance of acquisition value mean that the assumption of generational adjustments may not be accurate.

Nor are the taxes themselves the only aspect of Proposition 13 that raise issues of equity:

One of the most important but least studied aspects of Proposition 13’s legacy has been its effect on young, first-time home buyers, who get hit with double and triple whammies. When they buy their first home -- say a

¹¹*Nordlinger v. Hahn*, 505 U.S. 1, 29 (1992) (dissenting opinion).

¹²Robert Reinhold, “Fight Over California Taxes Reaches U.S. Supreme Court,” *The New York Times*, March 1, 1992, p. 1.

\$150,000 house -- their property tax equals \$1,500, 1 percent of the purchase price (and usually more with additions).

That's not only a hefty tax to add to the monthly house payments, it's often three or four times more than what older, long-settled neighbors pay for their homes, which may be worth a lot more than \$150,000, but which are assessed on 1975 prices. The tax disparity is also another example of government policies that favor the older, more affluent generation over younger workers struggling to afford a house in the nation's most expensive housing market.

But what's even worse is that people who buy homes in new subdivisions must also pay huge development fees to finance the public infrastructure around their new homes: schools, roads, sewers, water, and police and fire services. Before Proposition 13, all property owners in a given community financed these costs out of their property taxes, sharing both the burden and benefits of an expanding economy.

Since Proposition 13, however, only new home buyers and developers pay for community infrastructure improvements. To the degree these improvements benefit the entire community and raise the cost of new housing, the value of the older homes goes up. All the burdens fall on the younger buyers, but the economic benefits flow to older property owners protected by Proposition 13. That's the double whammy.¹³

The unassailable political support for Proposition 13 suggests that a crucial index of equity for California voters is predictability. The tax may bear no relation to the tax on similar property, but it bears an absolutely predictable relation to future taxes on this particular property. Moreover, rate and assessment limitations temper the impact of inequities in the property tax burden. It is logical that the absolute reduction in property taxes brought about by Proposition 13 reduced the perceived importance of distortions in the distribution of this smaller tax burden.

This may be the most realistic interpretation of the California experience, but it is a sobering commentary on aspirations for tax equity if no greater demands are made on the fairness of the tax than avoidance of disastrous uncertainty. A solution to the problem of volatility that depends on drastically reduced tax collections must take into account either alternate means of raising these revenues or the consequences of decreased government

¹³John Jacobs, "Prop. 13 Unkind to Young Home Buyers," *The Fresno Bee*, July 20, 1997, p. B7.

spending. Although the complexities of California's revenue needs defy easy categorization, the decline in many of its public services over the period of Proposition 13 is well known. *U.S News & World Report* summarized the general impression in 1998: "In the 1960s, California schools, parks, highways, and public universities were the envy of the nation. Today, because of cuts in property taxes and a reluctance by older, wealthier Californians to pay for services they don't personally use, public services in the Golden State are underfunded, overcrowded, and in some cases literally crumbling."¹⁴ A 1997 *New York Times* editorial pointed out that California "now ranks 43rd nationally in education spending -- well behind comparable states like Texas, New York and Pennsylvania -- and spends about \$30,000 less per classroom per year than the national average"¹⁵ In January, 1998, the Pew Charitable Trust assigned the state school system a grade of D- for fair and adequate school funding.¹⁶ To the extent that resources are deemed inadequate, the impact on those resources of measures to address volatility must be taken into account.

Proposition 13 and Volatility.

Perhaps the greatest irony in these developments is that current increases in housing prices have produced sudden and unexpected rises in property taxes in – California. How could this be? Purchasers who acquired their property just before the drop in prices of the California recession of the early 1990s frequently saw the sale value of their real estate fall below the price they had paid. The original text of Proposition 13 as approved by the voters in 1978 so reflected the Californian optimism as to ever-rising property values that it did not even address how reductions were to be treated under an acquisition-value system. That oversight was quickly remedied, and Proposition 8 provided that reductions in value were to be reflected in full in the tax assessment, although increases could not raise assessments more than 2 percent annually.

But what of later market increases that brought values back to the acquisition price, and above? At that point, assessments could rise as well, constrained only by the restriction that they not exceed the original purchase price, together with the annual inflation adjustment. This is the situation that many homeowners faced in the past year. As the *San Diego Union-Tribune* explained:

Thousands of San Diego County homeowners recently received a good news-bad news message from the Tax Assessor's Office.

The good news: Your property values have finally gone up.
The bad news: So must your property taxes.

¹⁴Matthew Miller, "Explaining California's 'Mississippification,'" *U.S. News & World Report*, May 18, 1998, p. 32.

¹⁵Brent Staples, Editorial Notebook; "How California Betrayed Its Schools," *The New York Times*, February 10, 1997, p. A14.

¹⁶Elaine Woo, "Report Gives Low Marks to State Schools," *Los Angeles Times*, January 17, 1997, p. A3.

The recipients are mainly property owners who had the misfortune to buy at the height of the last real estate boom in the early 1990s, then watch as values sank on average by 20 percent when the market scraped bottom in 1995-96.

For the past couple of years, however, they've enjoyed a kind of consolation prize -- reduced property taxes. That has meant savings of nearly \$16 million to owners of some 208,000 county properties, both residential and commercial.

. . . .

The Robinson family (who requested that their real name not be used) of Poway paid \$313,000 for their home in a new development in 1990. When the developer went belly up, home prices dropped by as much as \$50,000.

So when a letter arrived several years ago saying their property had been reassessed because of falling market prices, recalls Diane Robinson, "We thought that was great."

Several weeks ago, when they got a notice saying their home's assessed value had been partially increased from \$285,000 to \$359,000 for the 1998-99 tax year, they were initially taken aback and wondered whether there had been a mistake.

Craig Rustad, a division chief with the Assessor's Office, explains that the increase in the value could easily be justified by the 2 percent inflation factor allowed for each year since 1990, which would bring the value up to \$353,564, plus the \$16,000 backyard swimming pool the family added in 1993.¹⁷

Conclusion.

It is certainly ironic to encounter this volatility in the state where Proposition 13 has been in force for two decades. Yet there may be a larger lesson here as well. There is no anti-tax image more powerful than that of helpless senior citizens displaced from their family homes by price rises over which they have no control and from which they have no benefit. Yet this nightmare scenario can deflect attention a more widespread but less

¹⁷Ann Perry, "Taxes Hitch a Ride on Rebounding Property Values," *San Diego Union-Tribune*, July 26, 1998, p. I-1.

devastating phenomenon: the preference to pay fewer taxes rather than more, when that is a choice.

Consider the availability (and unpopularity) of tax-deferral programs for senior citizens – these obviate the problem of dispossession, but do not reduce the final tax burden. Consider efforts to extend tax freezes to new construction, new purchases, and new generations – none of which threaten dispossession from a long-held residence. Consider even that the wildly popular Proposition 13 did not abolish volatility but greatly reduced the state's property tax burden. These issues are often mingled in public debate, which can be problematic when policies intended to alleviate one problem have no effect on, or even exacerbate, underlying and unarticulated causes of dissatisfaction.

From one perspective, this is a dispiriting conclusion for the policy analysts and officials who have attempted to address the volatility problem on its own terms. It may be only one part of the problem – and not the largest part. Dislike of property taxes extends to those who are not threatened by price volatility but who find the nightmare scenario an effective illustration of the tax's shortcomings. This larger constituency will not be mollified by practical measures such as tax deferral that address volatility concerns but preserve an ad valorem tax base.

However, from another perspective, this hypothesis might hold good news for the property tax. If in fact the nightmare scenario of displaced property owners victimized by rampant inflation can be addressed, the larger causes of dissatisfaction can be debated without recourse to all-or-nothing rhetoric. The understandable and nearly universal dislike of high-profile local property taxes may be weighed against the alternatives: lower public spending, similar spending achieved with less accountability through less visible taxes, or shifting tax and spending decisions to other levels of government. A debate on these terms will be far more complex and nuanced than one motivated by nightmare scenarios, and more likely to improve local fiscal policy.