FINANCE

Some Sensible Approaches to Property Tax Reform

Cutting this unloved levy has again become a flashpoint in some states, once more raising difficult issues of fairness. Here's what we can learn from decades of tax-limitation laws.

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A house on the market in San Diego. Proposition 13 resulted in a "horizontal equity" issue, in which two comparable homes sitting next to each other can pay hugely different taxes because of when they were last sold. (Phillip Molnar/San Diego Union-Tribune/TNS)

It's like clockwork: After a few years of rapid increases in home values that make owners feel richer, they face higher local property tax bills that cannot be paid from their paper profits. Municipalities and school districts turn to the higher property assessments to reap new revenues to pay for inflated costs, higher employee salaries and new expenditures that they otherwise couldn't afford. Then state politicians and tax-revolt associations jump into the act. Their usual political impulse is to strip away those "windfall" revenue increases by dialing back the local taxes and erecting new voting requirements for future increases, with or without compensating state aid to the affected localities.

In a few states, legislatures have coughed up money from the state treasury to provide property tax relief. Texas has two such approaches under consideration right now. Often that tactic works until the next economic recession, when state revenues plunge and local budgets suffer a fiscal double whammy. Even now most states lack the financial surpluses to afford this approach, leaving their lawmakers with few alternatives but to impose limits of some kind on the locals. If they fail, more draconian tax-cutting ballot initiatives could spring up in the next election cycle.

But as much as many people hate the property tax, it remains the most reliable and durable source of local government revenue, and it can actually prove to be homeowner-friendly if it's well designed with fair rules for revenue limitations, representative democracy and voter approvals.

The granddaddy of all previous tax limitation measures was California's famous Proposition 13, enacted by statewide ballot measure in 1978. It set a cap on total tax rates and limited annual taxable property assessment increases to 2 percent for each parcel until the next time it is sold. Any increases in local tax rates have required a supermajority vote ever since.

After 47 years, California's disparity between tax assessments on properties recently sold versus those held by the same owner have widened dramatically. As a result, there's a huge "horizontal equity" issue, in which two comparable homes sitting next to each other can pay hugely different taxes because of when they were last sold, that especially irks newcomers and homebuyers. But the now-vested interests of older homeowners, farmers, landlords and property-intensive businesses have consistently beat back efforts by school associations and employee unions to peel back some of the restrictions — even when most households could have benefited from a more rational distribution of tax burdens.

Other states have since implemented a variety of tax limitations, revenue constraints and voting requirements. Voters approved new limits in several states last November. The result is a patchwork of state-specific rules for property assessment practices, tax rate limitations, revenue caps and local election requirements.

Those restrictions on local revenues are unlikely to be removed any time soon: Given the huge increase in property values across the nation in recent years, it's difficult to imagine that voters will roll back the tax limitations already on the books. In light of the recent national election results that favor government frugality, it's hard to believe that there's a groundswell of support anywhere for local tax increases to support yet more spending, except for isolated ballot measures for schools or public safety enhancements. Thus, much of the debate on property tax relief this year will need to center on what does the least harm to local services — especially long-term damage — with as much fairness as possible, while still placating aggrieved homeowners now stuck with escalating tax bills.

The various civic associations and the public finance community would do themselves — and all of us who care about local government — a favor if they were to develop and publish some feasible, defensible and actionable guidelines for sensible tax reforms and spending limitations. The Government Finance Officers Association has provided a conceptual technical framework but stopped short of the inherent, frictional political issues that arise when these debates heat up. Sensible reforms would require broad coalition-building, and there is no guarantee that "good government" advocates can ever sway a thundering reactionary herd in state capitals. But it's worth a try, to see whether voters actually want *fewer* government services or just *better* government services for the taxes they pay. Or do they simply expect something for nothing, functionally oblivious to budgetary realities?

Ground Rules for Fairness

One place to start is to level-set the ground rules for approving higher local taxes. It's not uncommon for the irate proponents of statewide tax limitations to seek language that requires supermajorities in future elections to increase taxes — even when their own proposals are enacted by simple legislative or referendum majorities. These requirements on their face are anti-democratic, but they appeal to the pent-up anger of the anti-taxers and especially the large property owners who only get one vote per person, if any, in local elections. So Sensible Ground Rule No. 1 should be that local tax increases can be approved by simple majorities in general elections, when voter turnout is greater, while special-election rules could still require a moderate supermajority, perhaps 55 percent, to offset the typical advantage of well-organized tax-to-spend factions in getting out disproportionate voting margins when turnout is low. That's a fair compromise.

The next step in taming the runaway property-tax beast is to limit the aggregate (not per-parcel) growth of tax revenues in each political subdivision to the rate of inflation, plus the greater of taxes on newly constructed property or a factor for population growth. That makes each jurisdiction's tax *rate* the corrective lever, not individual property valuations. Michigan adopted the states' first such constitutional revenue limitation back in 1978. Individual property assessments should reflect fair value and not some artificial number based on when the parcel was last sold. This formulation avoids California's horizontal equity problem.

For states that have already enacted limits on assessments rather than the revenues thereby derived, it's time to revisit their rules and limit the protections to natural persons only. Let businesses and those hiding behind personal trusts, LLCs and such all pay their taxes based on fair market value, with catch-up adjustments staggered over perhaps three years. Lucrative apartment buildings and houses owned for profit by companies and investment partnerships, already now on legislators' radar, certainly don't need or deserve tax caps. Corporate farmers should be obliged to pay taxes on fair market value and not the price of land 40 years ago. Family farmers could still enjoy some middle-class tax protection with an agricultural homestead provision, but only for those working full time on inherited property with a value below something like $5 million net of any mortgages passed down as liens on the farm property. Big dynastic family farming operations don't need cushy tax breaks to remain more profitable than their plebeian neighbors.

Like corporate real estate owners, all inheritors of real property should also face a three-year phased-in property assessment “true-up” to current value because their cost of equity ownership is only the associated mortgages and there is no justification for them to also inherit tax breaks at their communities’ expense.

Limits on Revenue

For such assessment policies to work politically, experience shows that legislation or ballot proposals must also put a “windfall” limit on the total revenue derived from the measures so that the resulting revenue does not escalate by more than inflation and the aforementioned growth factors. Above that, the tax rate should be reduced correspondingly unless voters approve more. This way, most taxpayers — especially homeowners — would actually benefit from the systematic reassessment process. For those worried about lower- and middle-income senior citizens who have owned their primary residence more than 10 years, they can be granted an age-and-ownership-based offset that does not convey to their estate.

It should be noted that in California, the school associations and unions have tried and failed several times to amend Proposition 13. They overreached, trying to grab a revenue windfall. The taxpayer associations, chambers of commerce and business interests countered with successful public relations campaigns to convince voters that such tax adjustments would penalize fearful housewives and their families. That’s why it’s essential for any such reforms to include a “circuit breaker” rule that total revenues from local market-value reassessments must also include an offsetting tax rate cut for everybody if the resulting new revenue materially exceeds the statutory inflation and growth factors. Unions, the school lobbyists and PTA associations won’t like it, but a return to simple-majority election rules could give them good reason to side with the homeowners next time around. If they want more money, they should ask residents to approve increases and not rely on housing inflation to fatten local payrolls.

For taxpayer groups who consider these limitations to still be insufficient in constraining local spending regardless of the funding sources — including sales and income taxes — an additional rule could be invoked in state law to require approval [illegible]t least 60 percent of all voting seats on local governing bodies (not the entire [illegible]torate) to increase total annual spending by a rate that exceeds inflation plus population growth, plus prudent, restricted risk-based rainy-day set-asides for recessions and natural disasters. (A rainy-day funding exemption for all these tax-limitation measures would actually be a worthy idea, albeit politically challenging.)

Rollbacks, Freezes and Austerity

Although these suggested reforms should address these issues prospectively, there may still be some agitated taxpayer groups who want vengeance, or at least a return to some prior year's taxation levels, before local levies skyrocketed at successive double-digit annual rates. That can best be accomplished by a multiyear tax-revenue freeze that continues to apply until the jurisdiction's future tax receipts no longer exceed its base-year level as adjusted for inflation and growth.

Of course, such measures would unhappily require budget cuts for some big-spender local governments, but if the measures are sensibly enacted and frugally implemented, most entities can shrink their operating costs through personnel attrition — or alternatively seek voter approval for modest tax increases needed to sustain generally popular service levels by overriding their revenue caps.

Whenever legislators discuss tax limitations, municipal and school associations understandably cry for state reimbursements of foregone revenues. Yet with states today facing the prospect of cutbacks in federal financial aid and grants, Medicaid and education funding, most are already financially strapped or disinclined to now make their political subdivisions whole for lost property tax revenue. Thus, some compromises in legislative design and reasonable voting rules could help the state politicians save face by "doing something" about property taxes, but leaving the revenue remedies to local politics. They can declare victory in taming the beast, and move on to other issues.

Voters are grouchy, and scattered double-digit property tax increases have stirred up numerous hornets' nests, giving tax-cutters and the loudest legislators a stage for performative political theater in state capitals. Local officials and their associations in those states need to promote feasible solutions, or lose control of their destiny.

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