FINANCE

The Impulse to Rethink the Unloved Property Tax

Progressives dislike its regressivity, but states and localities depend heavily on the revenue. Some reformers' eyes are on taxing luxuries and digital intangibles — NFTs, anyone? — but that presents its own problems.

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A suburban neighborhood in Los Angeles, Calif. (trekandshoot/Shutterstock)

Back when the United States was founded, land and buildings were the primary forms of wealth. Agriculture was the backbone of the national economy, and state and local taxes on physical property were typically their primary revenue source. Our young nation's first industrial corporations and the New York Stock Exchange were just getting started by the early 1800s, and the Age of Invention and its ensuing wealth creation came almost a century later.

West Virginia enacted the first state sales tax in 1921. States didn't begin imposing income taxes until the early 1900s, and it took a 1913 constitutional amendment to establish a permanent federal income tax. Mostly, though, the concept of progressive taxation played second fiddle to mantras of uniformity and equal protection. A hundred years ago, nobody could have dreamed that taxes on capital gains from paper assets would ultimately become the most progressive and dynamic element of the nation's multi-tiered tax system.

With all those new forms of taxation, property taxes have diminished as a share of state and local revenues, to a little more than 30 percent, but they still generate more than 70 percent of localities' tax receipts. So it's hardly a surprise that today we are seeing renewed interest in property tax reforms and alternatives.

One source of creative dialogue is the movement to "rethink local government revenue systems," a popular bandwagon in the world of municipal think tanks and several professional associations. The central premise is that other revenue drivers may be more progressive, or at least less regressive, and that there are multiple economic spheres that now escape taxation that state and local governments should be pursuing, largely in the digital world. To this camp, for example, a property tax on imaginary "land and buildings" in the emerging "metaverse" would be a perfectly logical candidate for what I'll call "The New Taxation Paradigm." If the Revenue Rethinkers could just design a way to collect taxes on intangible assets without their owners relocating to another jurisdiction, that would be a dreamy solution. But alas, municipalities operate in earthly reality, not virtual reality.

The second foundation for property tax reforms comes from a more traditional and familiar impulse, which is angst over real-estate inflation. The recent rapid increase in property values is expected to drive property assessments higher at a rate well above the consumer price index. The ensuing real-estate taxes will hit hard, or at least disproportionately, on those with fixed and low incomes.

Today's property value inflation is running at levels similar to the mid-1970s, which ultimately resulted in property tax reform laws modeled in one way or another on California's still-controversial Proposition 13. Although the actual mechanics of these laws were state-specific, the end result was often a limit on property tax increases for existing owners. In some states, the total of such tax revenues allowed for local governments are curbed by state laws.

Forty-six states and the District of Columbia now have some form of property tax limitation on either the assessments or the dollars levied, although many of these are trivial from the standpoint of progressivity or inflation adjustment. Several states, for example, allow simple income-based circuit-breakers for senior citizens and veterans who are given a credit locally or on their state tax returns. In a few states, there are now hard-wired state-level income- and sales-tax offsets that provide some level of compensatory formula-based replacement revenues to local governments whose property taxes are capped.

For perspective, California is the granddaddy of all the statewide property tax limitations and revenue-loss offsets, especially now that Prop 13 has been on the books for more than four decades. That time span has now amplified its predicted distortions in tax burdens and inequity, to the point that reformers can't help but dwell on its shortcomings. So let's start there.

A Recipe for Revolt

Putting partisan and factional politics aside, Prop 13's broad-based voter support springs from the long-standing tendency of property prices in the Golden State to keep escalating at rates well above the national inflation rate. In-migration and other population growth made land increasingly scarce and pricey, while environmental laws and land use controls made construction increasingly costly. When senior citizens found themselves facing property tax bills that forced them to abandon their lifelong homes to seek lower-cost and lower-taxed housing, a political tipping point was reached. Add to that a strong lobby by farmers, landlords and business owners, and it was a recipe for revolt.

The result was the 1978 constitutional amendment limiting the annual increase in property tax assessments to 2 percent per year, plus the value of any improvements, until a property is sold — at which time the valuation jumps back up to market levels. Tax rates can only be increased by a supermajority vote.

As a blunt instrument to protect senior citizens living on modest fixed incomes after decades in the same home, Prop 13 has worked well. But it’s also invited numerous abuses. Lawyers soon found ways to create ownership trusts and private partnerships that could be conveyed while still holding title by the same entity, making the tax curtailment a transferrable right. This works like a charm for crafty households as well as savvy farmers and businesses, thus providing a huge loophole for wealthy families and corporations to enjoy their tax caps in perpetuity, while ordinary people who sell and buy property in their own names during their lifetimes end up footing an ever-increasing share of the local tax burden. Progressives would say that much of the tax relief is now going to exactly the wrong parties.

The amount of tax avoidance has grown so large that the school associations and public employee unions whose wages were curbed by the 2008 recession made several efforts to put a tax reform proposal on the statewide ballot. Their efforts were painted as a money grab, and the anti-tax lobby came out in force with misleading TV commercials portraying a mousey, frightened “Heather Homemaker” worrying aloud that the price of her family’s food and necessities would skyrocket because farmers and businesses would soon be burdened by skyrocketing tax increases. Their skullduggery worked, and voters have repeatedly rejected efforts to curb the inequities of Prop 13.

The national lesson from all this is that property tax reform efforts need to focus first on the most glaring inequities. Focus the tax caps on senior citizens and low- to moderate-income taxpayers, and protect working family farms with landholding values below the top quartile. As for businesses, it’s pretty hard to make an excuse for granting a perpetual tax cap: Such relief should be limited to actual people and not given to transferrable entities or multi-generational trust funds. Inherited property is a windfall to the recipient; Silver Spooners neither need nor deserve Grandma’s property tax breaks.

Whether it's the property assessment, the municipality's revenue line item or the actual tax bill itself, the benefits of property tax relief need to be much more tightly limited and focused. Voters need to be convinced that the additional revenue will be used to reduce overall tax rates, fund pension deficits and OPEB liabilities, and pay down municipal bonds, not to ignite runaway spending. If they ever hope to rebalance the scales, reformers need to blunt the anti-taxer's hatred of perceived public employee union payola and largess.

Taxing a Mobile, Digital Society

The Revenue Rethinker crowd is intrigued about taxing non-traditional forms of property, but they haven't yet solved the practical problem of geographical mobility. Several states have abandoned intangibles taxes (on paper assets like stocks and bonds) because they learned that many rich residents will just locate elsewhere if the rate is onerous enough to make avoidance worth venue-shopping. Property taxes on moveable luxury and digital assets — whether it's Picassos, yachts, cryptocurrency or non-fungible tokens (NFTs) — could be highly progressive, but they'd be maddeningly intrusive, hard to enforce equally and administratively a nightmare.

For digital commerce taxes, a multi-state compact could be an ideal solution, with revenues shared on the basis of total populations, but selling that idea in Congress or to red-state legislatures is either a tall order or a fool's errand. In the meantime, real-world reformers should focus on the worst distortions in the current revenue scheme and then promote reforms that are actually achievable.

Meanwhile, if interest rates keep escalating as many expect, property prices may cool down somewhat and take the political heat off of local governments. Otherwise, it's conceivable that this year's annual assessment notices could spur yet another wave of legislative and maybe even ballot initiatives to put new or tighter lids on property taxes. Either way, the search for alternative revenues is gaining steam.

The rapid growth of digital commerce and virtual entertainment is an alluring invitation to new taxing schemes. Taxpayers and voters will be more supportive of those that include a plan to put the money to sound and prudent uses and avoid showering new revenues on union or ultra-blue free-spending interests that are easy targets for anti-taxers.

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Girard Miller

Girard Miller is the finance columnist for *Governing*. He can be reached at millergirard@yahoo.com.

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