What Policy Makers Should Know About Property Taxes

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Although property taxes continue to be a fundamental and important revenue source for local government, they also remain exceptionally controversial. The common, overarching objection to property taxes is that they are "unfair"—unfair in their distribution across income classes; unfair to particular groups of taxpayers (e.g., homeowners, senior citizens, farmers); unfair because increases in property value are taxed without a cash gain to offset the higher tax; unfair because of inept or corrupt administration; unfair for funding education because of wide disparities in property values; and so on (Youngman 2002).

Economists and other tax analysts express different concerns about the consequences of property taxes, including their effects on efficient housing consumption, on the location decisions of both households and businesses, on the supply of capital and use of capital in production, and on local government decisions about the efficient quantity of public services (Zodrow 2008).

As a consequence of these varied concerns, the property tax seems to be continually under assault—the target for reform, reduction, or even elimination. The adoption of Proposition 13 by California voters in 1978 was a key event in the widely termed "property tax revolt." Voters in other states subsequently adopted limitations similar to California's or enacted exemptions, abatements, credits, or special features to reduce or constrain property taxes for various groups. In the 1980s and 1990s, state legislatures reformed the financing of education, sometimes as required or encouraged by litigation, which decreased or changed the structure of property taxes and often substituted revenues from other sources.

In recent years the property tax revolt has been resurgent as a number of states have considered proposals to reduce or even eliminate the property tax by expanding alternative revenues. Because many of these proposals substitute increased state taxes and new intergovernmental grants for local property tax revenues, they may reduce the fiscal autonomy of local governments while also decreasing reliance on property taxes.

Reflecting President Kennedy's (1962) warning that "too often we hold fast to the clichés of our forebears," many popular comments and criticisms of property taxes either reflect outdated views on the state of tax administration or ignore recent research that provides a new and substantially different perspective. This is, of course, as much the fault of tax analysts as it is political officials. Still, the topic of property taxation seems to be one for which improved education and understanding is especially necessary. The following considerations may help clarify some important aspects about using property taxes as a source of local government revenues and a mechanism for financing local services.

Property Taxes and Local Governments

Property taxes are the financial foundation for local governments.

The $346.3 billion of property taxes collected in fiscal year 2005 accounted for about 28 percent of all local government general revenue, but it constituted nearly 75 percent of local government taxes. As the primary revenue source directly controlled by local governments, the property tax has been central to local fiscal autonomy.

Property taxes provide about a third of general revenue for public schools nationally, about a quarter of revenue for county governments, and about 20 percent of revenue for cities (figure 1). Townships, many of which provide public services in more rural areas, depend on property taxes for more than half of their revenue. Overall, the share of local revenue from property taxes decreased in the 1960s and 1970s, but has remained fairly constant in recent decades.

Replacing all property taxes would require more than doubling state sales taxes.

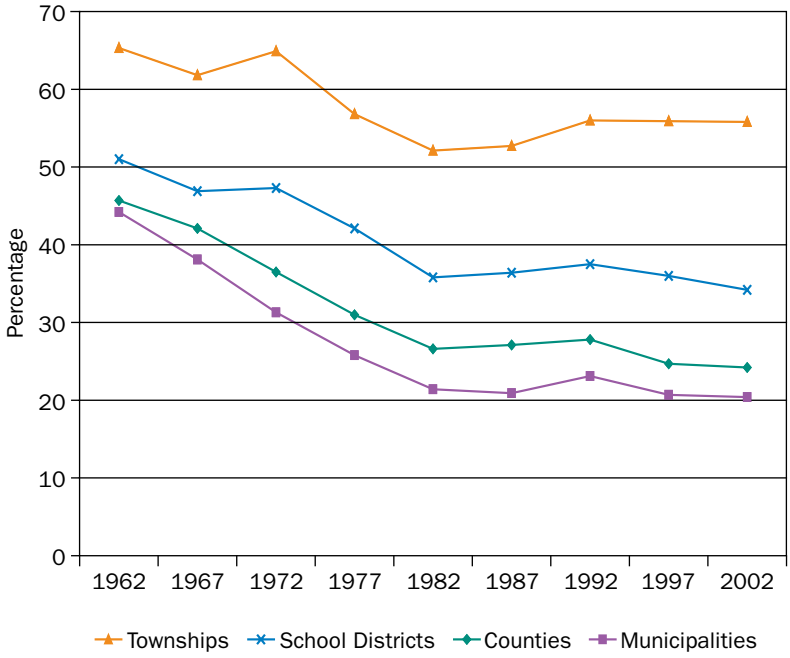
Total property taxes, sales taxes, and corporate income taxes collected by all U.S. governments are roughly of the same magnitude—in the $350 to $450 billion range (figure 2). In 2005, property taxes ($346.3 billion) were essentially equal to federal and state corporate income taxes ($355 billion), but greater than both general sales taxes ($271.2 billion) and selective excise taxes (such as gasoline and cigarette taxes, $197.8 billion).

Accordingly, if all property tax revenue were to be replaced by higher general sales tax revenue without any change in the sales tax bases, state sales tax rates would have to increase by 125 percent. Assuming the average state and local general sales tax rate is about 7 percent, rates of 15 or 16 percent would be needed to replace all property taxes with no change in sales tax bases. Similarly, property tax revenue could be replaced by doubling all state and federal business income taxes, although the trend in recent years has been to reduce business taxes.

Property taxes have been responsive to economic growth and relatively stable over time.

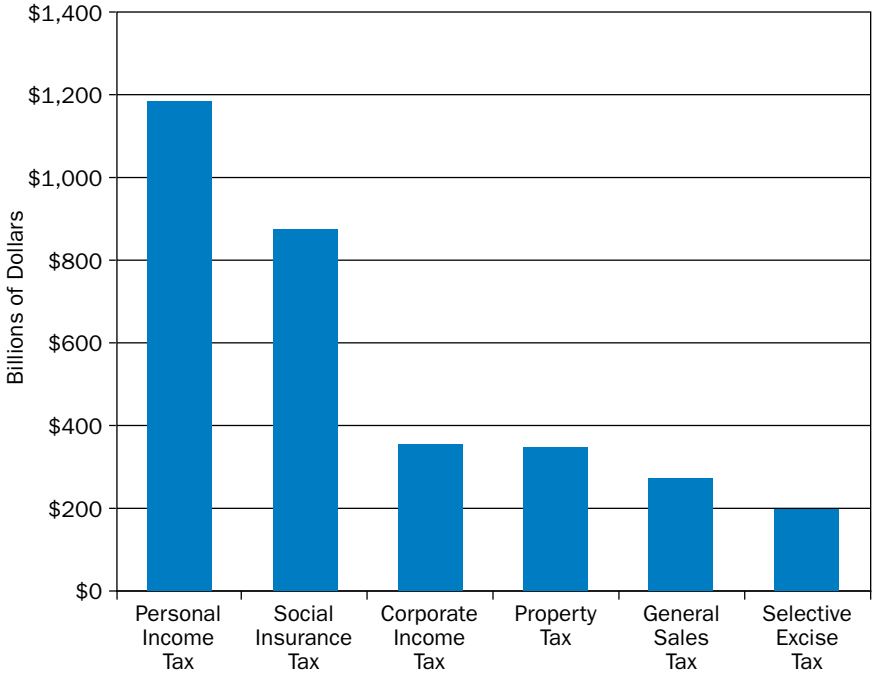
Two key questions for all taxes concern their long-run budget implications. Does the tax base grow

FIGURE 1
Property Taxes as a Percentage of General Revenue, by Type of Government, 1962–2002



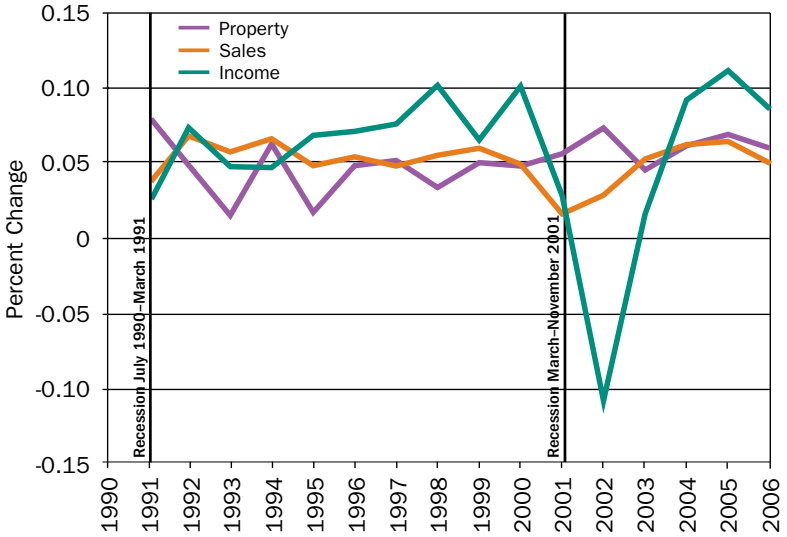
Source: Fisher (2007).

FIGURE 2
Total Taxes Collected by Type Across All U.S. Government Levels, 2005



Source: Fisher (2008).

FIGURE 3
Volatility of State and Local Tax Revenue, 1990–2006



Source: Kenyon (2007, 41)

automatically in response to economic growth? And to what degree does the tax base vary from year to year as the economy fluctuates? The first question is important because demand for public services normally increases with economic (income) growth, requiring additional revenue to provide additional services. Second, if a tax base varies substantially as national economic conditions vary, then budget planning becomes more difficult.

Property taxes have been a stable revenue source (especially compared to sales and income taxes), varying the least across years among all the major state taxes (figure 3). The short-run stability of the property tax base reflects the economic fact that capital investment (both residential and business) is by nature a long-run decision influenced more by long-run expectations than short-run economic circumstances.

Accordingly, property values traditionally have not declined substantially with each recession, and when they have declined, the typical lag in assessments has maintained taxable property values at least through the first part of the economic downturn. Indeed, in some cases, property tax bases were countercyclical, growing at the times when sales and income tax bases were declining.

Property values in the United States have reflected long-run economic growth, so that (until recently) property tax revenues also increased in response to growth (second only to personal income taxes). Property values, especially residential values, also have increased in response to new family formation, suburbanization, improvements in transportation, and new business investment. At the same time, improvements in assessment practices have permitted property assessments for tax purposes to reflect these increasing market values.

Property Taxes and Homeowners

Typical homeowner property tax payments are between $125 and $150 per month.

Total property taxes on all types of property in the United States have remained at about 3 percent of total personal income since 1982 (increasing modestly from about 2.85 percent in 1982 to 3.15 percent in 2005). Recent research shows that the median effective property tax rate on all real property (residential and nonresidential land and buildings) is about 1.7 percent of total property value (Gravelle 2007).

What is the "typical" property tax liability for a homeowner? The 75 million year-round, owner-occupied housing units existing in 2005 had a median market value of $165,344 and median monthly real estate tax of $127 (U.S. Census Bureau 2005). The median owner-occupied home value had risen to about $191,000 by 2007, with a median monthly property tax of $144 (U.S. Census Bureau 2008).

With the recent housing market crisis, prices have declined from the peak 2007 levels (so that the 2005 data may be more accurate now). Therefore, half of U.S. homeowners pay less than $125 to $150 per month in property taxes. The median homeowner had annual property taxes of $1,524 in 2005 and $1,728 in 2007, and an effective property tax rate of less than one percent (.9 percent) of property value in both years.

Of course, property tax amounts vary among homeowners because tax rates differ among communities, and homeowners have properties of different values. A homeowner with a median-value home can expect annual property taxes of $1,500 to $3,300, or roughly $125 to $275 per month if tax rates are higher than average (see table 1). A homeowner with a $300,000 home (about at the 75th percentile of owner-occupied houses in 2005) could expect annual property taxes of $2,700 to $6,000 ($225 to $500 monthly), again depending on tax rates.

Concerns about homeowner property tax burdens can be mitigated with targeted tax adjustments.

Nearly every state has programs to reduce or limit property tax burdens for selected homeowners, so that net tax amounts are often lower than indicated by the American Housing Survey. For instance, 40 states provide homestead exemptions or credits; 34 states and the District of Columbia provide property tax rebates or credits (often called circuit breakers) that apply if property taxes exceed some specified percentage of income; and at least 25 states and the District of Columbia provide property tax deferral options to prevent owners from having to sell a house to pay taxes (Baer 2005). Eligibility for many of these programs is determined by income or wealth, or is targeted to specific taxpayers, especially senior citizens.

Another consideration is that property taxes may be "reduced" through federal income tax deductions taken by taxpayers who itemize their deductions. Federal deductibility can be a major advantage of local property taxes compared to local sales taxes, because under current federal tax law taxpayers who itemize deductions may deduct state and local property taxes and *either* income taxes *or* sales taxes. For states that have both income and sales taxes, it is almost always better for taxpayers to deduct the income rather than the sales tax.

Increases in property tax payments due to increases in property values may create a liquidity problem for households, especially when property values increase faster than incomes.

Property taxes are levied on the value of capital (primarily land, structures, and equipment) used in producing goods and housing services. In a well-functioning property tax system, the tax should be related to the market value of the property. If the market and taxable values of properties in a jurisdiction rise and the tax rate is kept constant (or 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. Because the increased value of an owner-occupied dwelling is not normally realized until the house is sold, taxpayers may face higher property taxes without additional income (cash) to pay the higher tax amount.

This issue may be especially problematic for individuals who purchase homes based on the maximum monthly payment that the household could afford. It also may be one of the two primary contributors behind calls for major property tax reduction or even elimination over the last decade, a period when housing prices increased substantially. The other factor is the relationship between property taxation and school funding equity (see Kenyon 2007).

The example of a household with a $100,000 income and a home with an initial value of $300,000 may be instructive (table 2). Initially, the household has a monthly mortgage payment of $1,600 and a monthly property tax payment of $250, so that housing expense is 22 percent of income. If over five years housing values grow 9 percent annually and incomes 3 percent, the value of the house will be about $460,000 and the household's income about $115,900. With a constant tax rate, annual property tax liability will rise from $3,000 to $4,600 and monthly property tax payments from $250 to $383—an overall housing payment increase of $133 per month. Although

TABLE 1
Illustrative Annual and Monthly Property Tax Amounts

Value Percentile	Market Value	Effective Tax Rates (annual/monthly)				
		0.90%	1.00%	1.40%	1.70%	2.00%
20th	$78,000	$702/$58.50	$780/$65.00	$1,092/$91.00	$1,326/$110.50	$1,560/$130.00
40th	$130,000	$1,170/$97.50	$1,300/$108.33	$1,820/$151.67	$2,210/$184.17	$2,600/$216.67
median	*$165,000*	*$1,485/$123.75*	*$1,650/$137.50*	*$2,310/$192.50*	*$2,805/$233.75*	*$3,300/$275.00*
60th	$200,000	$1,800/$150.00	$2,000/$166.67	$2,800/$233.33	$3,400/$283.33	$4,000/$333.33
75th	$300,000	$2,700/$225.00	$3,000/$250.00	$4,200/$350.00	$5,100/$425.00	$6,000/$500.00

Source: Author calculations based on the 2005 American Housing Survey.

TABLE 2
Illustration of Growth in Property Value and Property Tax Over Five Years

Market Value	$300,000
Household Income	$100,000
Value to Income Ratio	3.0
Mortgage Amount	$270,000
Monthly Mortgage Payment (principal + interest)	$1,600
Effective Property Tax Rate	1%
Annual Property Tax	$3,000
Monthly Property Tax	$250
Total Monthly Expense (principal + interest + tax)	$1,850
Monthly Housing Expense/Income	22%
Change After Five Years	
New Market Value (9% annual growth)	$460,000
Household Income (3% annual growth)	$115,900
Value to Income Ratio	4.0
Effective Property Tax Rate	1%
New Annual Property Tax	$4,600
New Monthly Property Tax	$383
New Total Monthly Expense (principal + interest + tax)	$1,983
Change in Annual Property Tax	$1,600
Change in Monthly Property Tax	$133
Change in Market Value	$160,000
Monthly Housing Expense/Income	21%

Source: Author calculations.

taxes have risen faster than income, the ratio of housing expense to income has fallen (from 22 to 21 percent), and the household's home equity has increased from $30,000 (the initial down payment) to roughly $190,000, a $160,000 capital gain.

What are possible or appropriate responses to this situation? Of course, no policy response may be necessary, because homeowners in this situation are wealthier, at least on paper. Indeed, one could argue that many individuals purchased homes with the expectation and desire that the value would increase. Recall that a home value of $300,000 was in the top quartile of all year-round owner-occupied homes in 2005.

Two programs have been used by states and localities to deal with this concern. The first, circuit breakers, provides tax credits or rebates when property tax amounts exceed some threshold of income. If property taxes rise faster than income, then a circuit breaker credit or rebate may effectively reduce the amount of the tax increase. A second possible solution is to permit households to defer property tax payments (or at least the increase in payments) until the house is sold. For the $300,000 house example, if the owner sold the house after five years and had deferred only the *increase* in property tax amounts compared to when the house was purchased, the owner would owe about $4,560 in back taxes (plus interest), but would have a $160,000 capital gain from which to pay the deferred tax.

Distribution of Property Tax Burdens

The overall distribution of property tax burden seems to be roughly proportional to income for the bulk of middle-income taxpayers.

Research shows that for a national uniform property tax on all property, a graph of effective tax rates (i.e., tax as a percentage of income) would be U-shaped with respect to current annual income—regressive (falling) for the bottom 30 to 40 percent of households, proportional for the majority, and progressive (rising) for the top 5 to 10 percent of households. The rising tax burden for the top 10 percent of taxpayers occurs because the national property tax would reduce the rate of return to all forms of capital ownership, thus imposing a relative burden on capital owners, who are concentrated at the top of the income distribution. If the same tax is compared to a measure of permanent or lifetime income, the overall tax burden is essentially proportional to permanent income.

The result is only slightly different if one accounts for variations in tax rates between communities or between types of property. Assuming that the differentially higher property tax burdens fall on homeowners and renters in higher-tax communities and consumers of goods produced with taxed property, tax burdens are regressive for the bottom

20 to 40 percent of taxpayers and proportional for the remainder (comparing to annual income). The overall result is slightly less progressive because of relatively lower estimated burdens for the highest income individuals. In comparison to permanent or lifetime income, the overall distribution of property tax burden becomes a bit more progressive.

Certainly, research does not support the popular view that sales taxes are relatively better for lower-income taxpayers. The distribution of property taxes and sales taxes are quite similar. Sales taxes tend to be mildly regressive compared to current annual income and roughly proportional with respect to permanent or lifetime income. However, there are at least two reasons to think that these estimates of overall property tax incidence may not be relevant for specific policy decisions considered by individual states or local governments, as noted next.

The expected economic effects of a specific property tax change depend on which governments change the tax, and how.

Because the distribution of burden depends on the nature of the tax (uniform or differential) and on the geographic extent of any property tax change, analyzing the overall incidence of a property tax must be done with care. First, a nationwide reduction in property taxes would benefit all owners of capital, proportional to the amount of capital owned. Such a change clearly would favor the rich, who own relatively more capital.

Second, if only one state eliminated the property tax, the benefit would go to landowners, housing consumers, and workers in that state. Whether such a change is pro-rich or pro-poor depends on the income level of workers and home-owners in that state and would differ greatly between states such as Connecticut and Mississippi. Third, if only one local government eliminated the property tax (by switching to a local income or sales tax, for example), the benefit of the property tax reduction would go almost exclusively to landowners in that locality. The distributional effect depends on the economic characteristic of those landowners, some of whom may not even be residents of the locality.

One needs to be careful of the "catch 22" inherent in this kind of analysis. It might seem that property tax reduction in all lower-income states would be a pro-poor policy for the nation. However, if one low-income state reduces property tax the effects would be progressive or pro-poor, but if all lower-income states were to reduce property taxes simultaneously, the effect would be similar to a national reduction in property tax. That is, the effect would be regressive or pro-rich because the benefits would accrue primarily to the owners of capital.

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To predict the income distributional consequences of changes in property taxes at the state and local level, it is important to know whether jurisdictions with relatively high property tax rates tend to be high- or low-income communities. The evidence on this point varies geographically, especially for local governments. Among states, however, the number of low-income states hurt by high tax rates is essentially offset by low-income states that benefit from low tax rates.

Under certain conditions, the property tax serves as the "price" for living in a given community and consuming the local government services.

Property taxes may become locational prices or fees if: 1) consumers choose residential locations based on the property tax and service package offered by the local government; 2) there are different communities from which to choose; and 3) there is some mechanism (such as zoning) to maintain the equilibrium (Fischel 2001). In such a situation, individuals who desire the same fiscal package are grouped together. If one community has high property taxes because residents demand a relatively large quantity of public services, its residents are simply paying for the services they use.

If property taxes serve as benefit taxes or fees in this manner, then the tax does not change rates of return to capital or create incentives for reallocation of capital between jurisdictions or uses. In this case, it does not make sense to consider the incidence of the tax separate from the provision of public services, because the tax simply reflects the demand for the services, with each taxpayer paying the cost of the desired consumption of local public services.

Whether to think of property taxes as taxes on mobile capital, or as fees for residing in a particular jurisdiction and benefiting from the services provided there, remains a controversial issue among some public finance analysts. Supporters of the benefit tax view cite studies showing that many metropolitan areas have numerous localities offering different services, each remaining relatively homogeneous, and that the popularity of complicated zoning rules may serve to maintain community homogeneity. Indeed, this perspective seems to apply quite well in suburban areas of relatively large metropolitan regions (see Inman 1994).

There is less agreement on whether this perspective applies to rural areas and large central cities. In rural areas, individuals may have few residential choices because of the geographic size of communities, or may find it infeasible to separate their work and residential location choices. This perspective also may not apply in large cities, which are inherently quite heterogeneous. Property taxes on homeowners in large cities, therefore, may not necessarily correspond to the benefits from public services, so the distributional effect of the tax may be important.

What This All Means

What might be said, then, in defense of property taxes relative to the main alternatives of income or sales taxes? Relatively modest property taxes for the representative homeowner (less than one percent of property value or $150 monthly) support a myriad of important local government services and have permitted local governments to function independently of higher-level governments. Property taxes are relatively visible and thus contribute to government accountability. Property tax revenues have been responsive to economic growth and perhaps the most stable of all tax bases. Property taxes often are economically efficient compared to alternatives, especially if they serve as local benefit charges. Finally, property taxes may add to overall tax progressivity compared to the alternatives; importantly, property taxes are in most instances more progressive than sales taxes.

Although some of the political policy concerns about property taxes thus seem to be inaccurate or exaggerated, it also seems clear that many of these concerns continue to influence policy decisions. If taxpayers or public officials object to property taxes on distributional, efficiency, or administrative grounds, the relevant questions to explore further are: how do property taxes compare to the alternatives; how can targeted adjustments be used to alter property taxes for selected taxpayers; and how important is it for local governments to maintain fiscal independence.

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