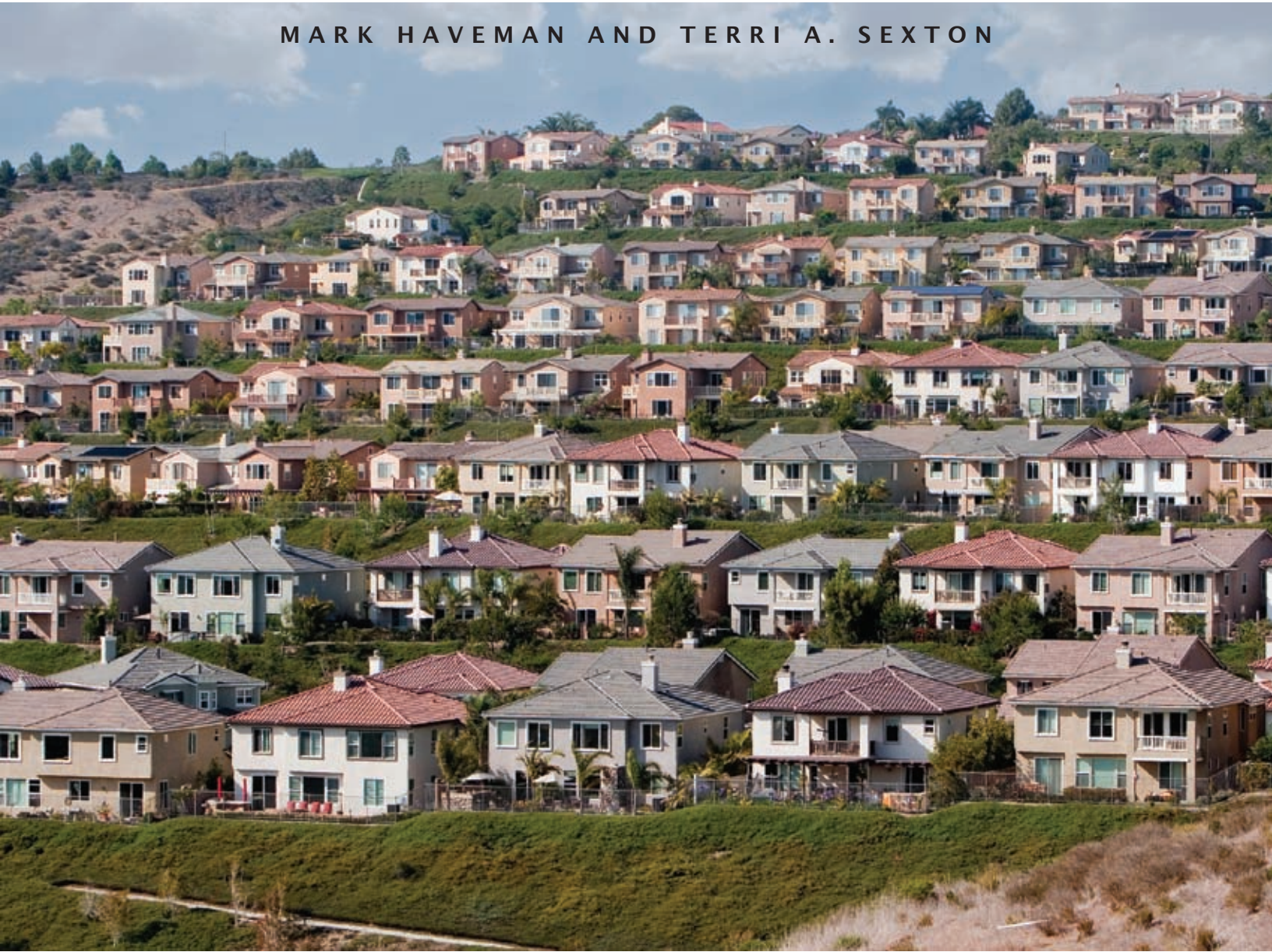




Property Tax Assessment Limits

Lessons from Thirty Years of Experience

MARK HAVEMAN AND TERRI A. SEXTON



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Policy Focus Report Series

The policy focus report series is published by the Lincoln Institute of Land Policy to address timely public policy issues relating to land use, land markets, and property taxation. Each report is designed to bridge the gap between theory and practice by combining research findings, case studies, and contributions from scholars in a variety of academic disciplines, and from professional practitioners, local officials, and citizens in diverse communities.

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Executive Summary

During the 30 years since California adopted the groundbreaking tax limitation measure known as Proposition 13 in 1978, there has been continual pressure for states to adopt various forms of property tax relief. These pressures often intensify during times of extremely rapid housing price inflation such as many states experienced between 1998 and 2006, but they remain a constant feature of the fiscal landscape in periods of both rising and declining values. The anniversary year of Proposition 13 in 2008 provides an opportunity to evaluate various states' experiences with a limitation on assessed property values, which has become one of the most popular instruments for tax reduction.

The evidence shows, however, that limits on assessed values, while favored by many homeowners, are a deeply flawed means to counter rising property taxes. They are offered in hope of reducing tax bills and slowing the shift in tax burdens to residential property, but in fact they can result in higher taxes for the very homeowners they are intended to assist and can cause unpredictable new shifts in tax liabilities. By severing the connection between property values and property taxes, assessment limits impose widely differing tax obligations on owners of identical properties, reduce economic growth by distorting taxpayer decision making, and greatly reduce the transparency and accountability of the property tax system as a whole.

Better alternatives exist for timely and efficient aid to needy taxpayers.

- **Circuit breaker programs** reduce taxes that rise above a given level of income, thus targeting assistance to those whose tax liabilities are out of proportion to their ability to pay.
- **Truth in taxation measures** lower the likelihood of invisible tax increases when property values rise but nominal tax rates stay the same.
- **Deferral options** allow qualified taxpayers to delay property tax payments and remain in their homes.
- **Partial exemptions** on owner-occupied or homestead properties and **classified tax rates** benefit residential taxpayers without distorting the market value tax base.

Fashioning timely and targeted assistance for those facing difficulty in meeting their property tax obligations is an ever-present challenge to state legislators. As economic conditions, demographic trends, and housing values change, so will the appropriate instruments for extending such aid. This report is designed to inform this process by identifying the lessons offered by three decades of experience with assessment limits as a vehicle for tax relief.



CHAPTER 1

The Roots of Taxpayer Discontent

Property taxes inevitably face greater scrutiny than less visible sources of government revenue, such as income taxes deducted before receipt of a paycheck or sales taxes collected in many small transactions over the course of a year. Their high visibility promotes governmental accountability and allows taxpayers to compare the benefits and costs of the local services they receive, but it insures that property taxes will always be controversial.

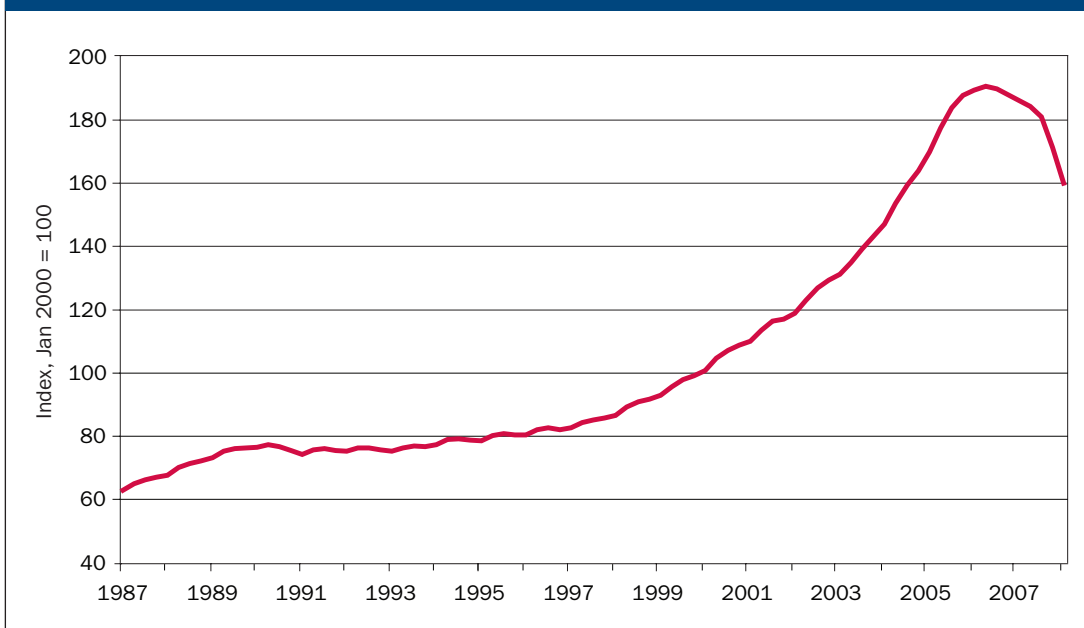
Explosive tax revolts are often associated with times of extremely rapid property appreciation. In California, Proposition 13 followed a period in the late 1970s during which taxpayers saw housing price inflation change from 5 percent a year to 5 percent a month. The period between 1998 and 2006 witnessed dramatic residential inflation

nationally, with housing appreciation almost twice the 62 percent increase from 1975 to 1980, when the current era of tax revolts began.

Figure 1 shows the increase in U.S. housing prices from 1987 through March 2008. After remaining largely unchanged between 1989 and 1998, housing prices rose by about 120 percent to their peak in mid-2006. Since then housing prices have fallen by about 16 percent. Thus, even after a large decline, housing prices in 2008 are, on average, nearly twice as high as they were in 1998.

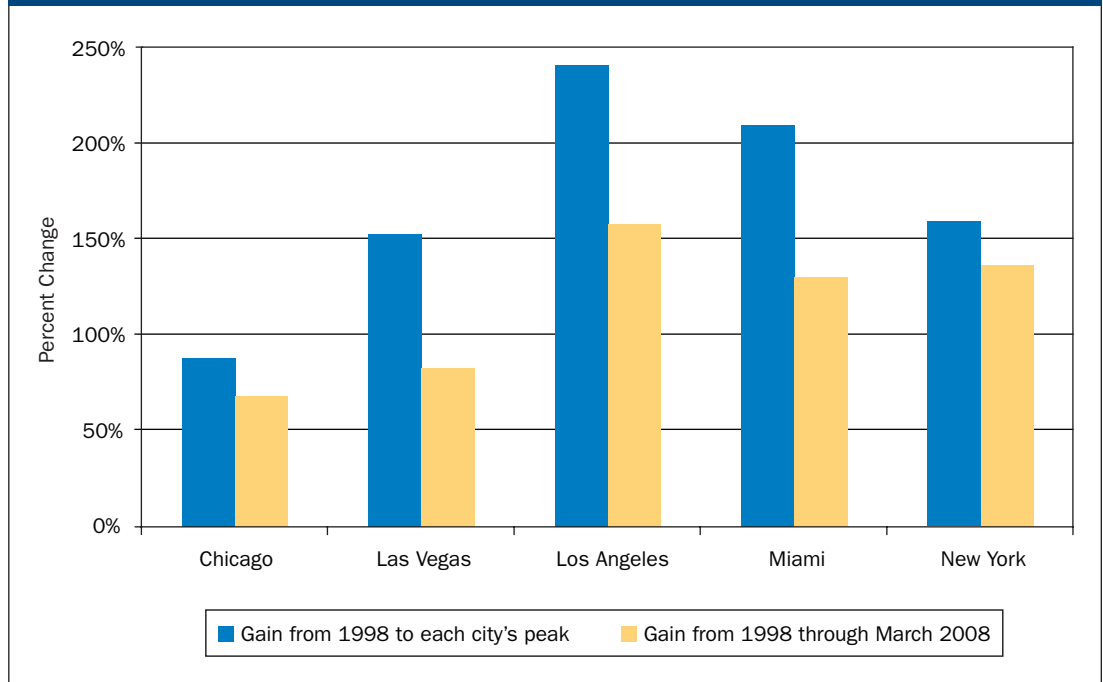
Figure 2 demonstrates this effect. Although housing prices have fallen since their peak in 2006, prices in Las Vegas are still more than 80 percent higher than they were in 1998; prices in Los Angeles are nearly 160 percent higher; and in Miami they are

FIGURE 1
S&P/Case-Shiller Home Price Index, 1987–2008



Source: S&P/Case-Shiller Home Price Indices, www2.standardandpoors.com. See notes on page 40.

FIGURE 2
Increase in Housing Prices for Selected Cities, 1998–2008



Source: S&P/Case-Shiller Home Price Indices, www2.standardandpoors.com. See notes on page 40.

130 percent higher. It is interesting to note that the 140 percent rise in housing prices in Los Angeles between 2001 and 2006 was equal to California's housing price increase of 140 percent between 1975 and 1980 (see box 1).

In Chicago and a number of other Midwest cities, housing price inflation since 1998 has been much more modest, as are the recent housing price declines. Average housing prices in Chicago have fallen from their peak, but they remain 68 percent higher than they were in 1998.

CAUSES OF DISCONTENT

In analyzing the causes of and remedies for taxpayer discontent, it is important to keep in mind that rising property prices in and of themselves do not necessarily increase property taxes. Rising property tax bills result from some combination of two factors: (1) rising local spending, which would

require higher collections and higher tax rates even if the tax base were unchanged; and (2) shifts in relative property values, which would increase some tax bills even if collections and rates were unchanged.

In most states, tax rates can be reduced to yield the same or even less revenue if desired. During the 1998–2006 housing boom, the growth of local property tax collections was less than half of the increase in housing prices—56 percent compared to 120 percent (U.S. Census Bureau, *State and Local Government Finances 2008*; Standard & Poor's 2008). Over the same period, however, personal income increased by 48 percent and median household income increased only 24 percent (Bureau of Economic Analysis 2006; U.S. Census Bureau, *Historical Income Statistics*).

Figure 3 shows U.S. property tax revenues as a percentage of personal income from 1992 to 2006. State and local property taxes

California's Proposition 13 and Related Measures

The property tax revolt began in California in the late 1970s. Although housing prices in the state rose rapidly during that decade, property tax rates did not fall proportionally, and many homeowners faced annual increases of 30 percent or even more in their tax bills. Property taxes also increased as a fraction of income, and the tax burden shifted from commercial property owners to homeowners. Taxpayers overwhelmingly approved Proposition 13 in 1978, and related measures followed during the 1980s.

Key Features of Proposition 13

- The maximum rate of property taxation is limited to 1 percent, excluding payments for preexisting indebtedness.
- The assessed values of all property were reset to their values in 1975–1976.
- Assessed values were then permitted to increase with the consumer price index, but not by more than 2 percent per year.
- A change in ownership triggers reassessment at market value, usually based on the new purchase price.

Key 1986 Amendments

- Known as the Dynasty Provision, Proposition 58 provided a family transfer exemption from reassessment on changes of ownership. Transfers of a principal residence and up to \$1 million of other property between parents and children are now exempt from reassessment. An earlier legislative exemption for transfers between spouses was made part of the state constitution.
- Proposition 60 allowed persons over age 55 to transfer the assessed value of their principal residence to a replacement dwelling of equal or lesser value in the same county without a change of ownership reassessment. This exemption is available only once in a lifetime. In 1988 this provision was expanded to allow senior homeowners to transfer their Proposition 13 base year value to a comparable dwelling in a different county if the receiving county agrees. Only 10 counties have agreed to accept such transfers.

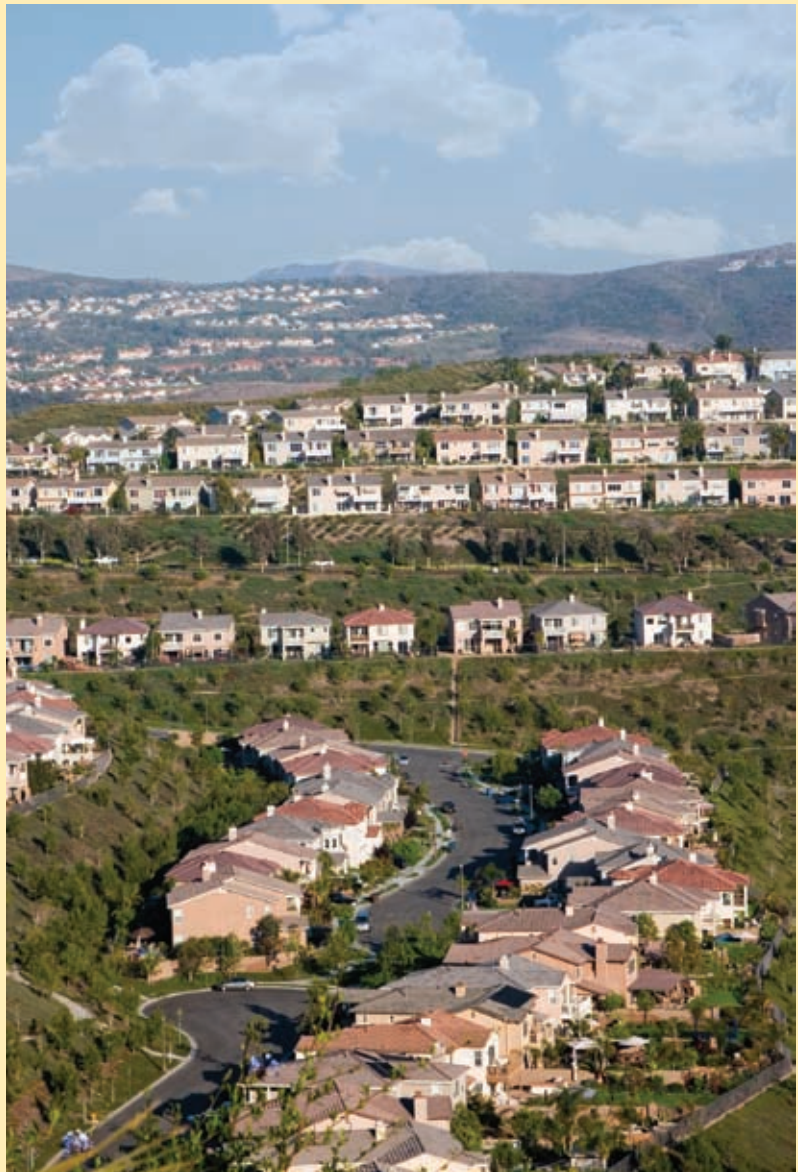
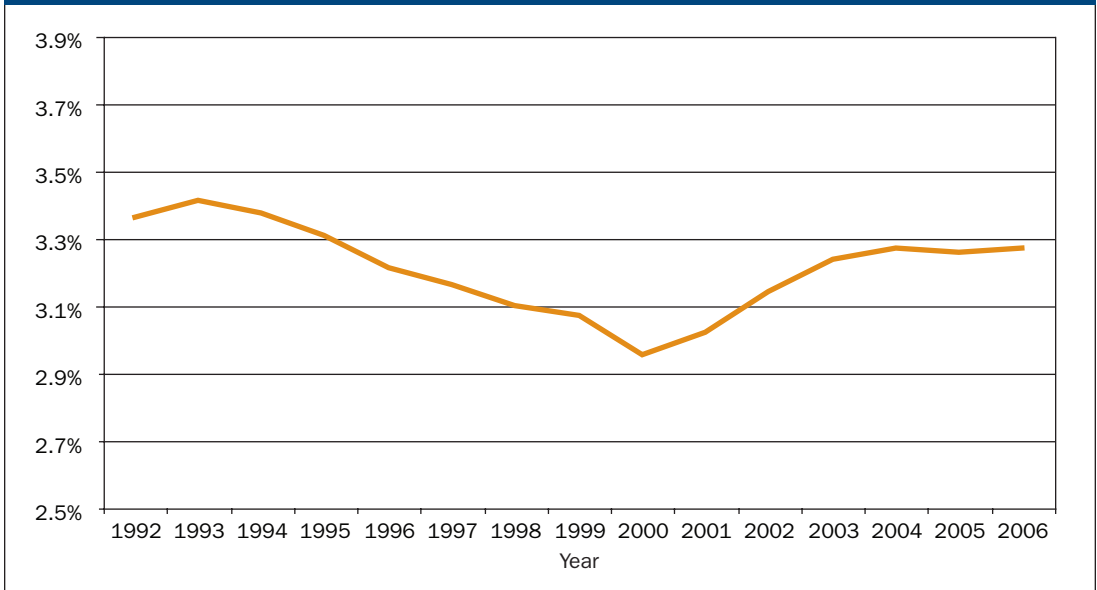


FIGURE 3
State/Local Property Tax as a Percent of Personal Income, 1992–2006



Source: Property tax data from Census of Governments (1992, 1997, and 2002), and State and Local Government Finances (other years); personal income data from Bureau of Economic Analysis.

declined steadily from 3.4 percent in 1993 to just below 3.0 percent in 2000. This pattern then reversed as property taxes began to increase faster than income, reaching nearly 3.3 percent of income by 2004. Since then property tax revenues have grown at the same rate as personal income.

There are multiple reasons for this pattern, and they vary across markets and jurisdictions. In addition to the rapid rise of residential values, other factors that likely contributed to the increase in property taxes as a percent of income include slow growth in personal income, increases in local spending, and heavier reliance by local governments on property tax funding, sometimes in response to cuts in state aid to local governments.

Because property tax bills are a function of many factors, including market changes, exemptions, assessment rules, tax rates, and credits, discontent with the actual amount to be paid may stem from many causes. Homeowners often feel they are bearing an

unfair share of the total property tax burden when residential property rises sharply in value. Figure 4 shows a modest but significant rise in the 2000–2006 residential shares of assessed values in a variety of states.

But, this trend may overstate the burden on owner-occupied principal residences, or homesteads, because the residential property tax base also includes rental apartments, second homes, and vacation property. For example, the chart shows a rise in the residential share of assessed value in Florida despite the Save Our Homes amendment that limits assessment increases to 3 percent annually. One explanation is that Save Our Homes applies only to homestead property, so the large amount of vacation property in the state does not receive the benefit of that cap.

Needless to say, the business community takes a different view of the shift in relative shares of assessed values between business and residential property. For example, this shift may reflect strong growth in residential

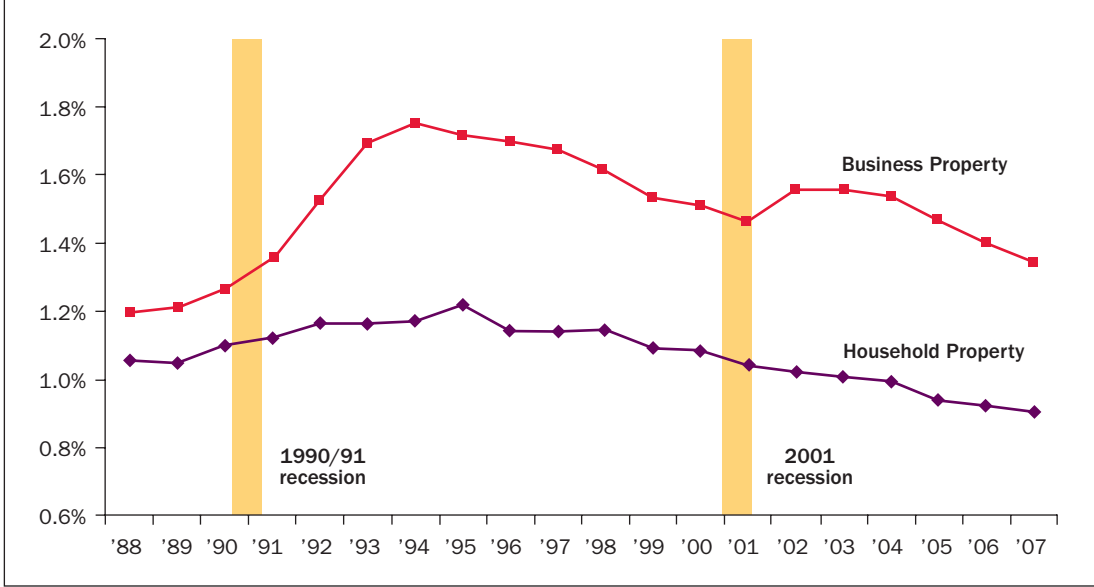


FIGURE 4
Residential Share of Total Assessed Value in Selected States, 2000–2006



Source: State departments of revenue or taxation.

FIGURE 5
Effective Property Tax Rates on Household and Business Property, 1988–2007



Note: Household and business property tax divided by value of household and business property.
 Source: Ernst & Young calculations; Phillips, Cline, and Neubig (2008). See notes on page 40.

values and stagnant commercial property prices. Looking at the tax rates, which translate assessed value into tax bills, figure 5 shows the results of a study comparing effective tax rates on household and business property. The much higher business rates

are not incompatible with an increase in the residential share of the tax base, because increased business tax rates are one means by which states may seek to moderate the effect of the rising residential share of the tax base.

Las Vegas has one of the highest rates of foreclosure in the country. Antitax activists in Nevada are seeking an assessment limit system similar to that in California.



Taxpayer discontent due to the increased burden on homeowners relative to their income and the increased homestead share of tax payments led lawmakers to introduce new property tax relief measures in 27 states in 2006–2007 (Hamilton 2007). Georgia Governor Sonny Perdue went so far as to propose a constitutional amendment to eliminate the state portion of residential property taxes. At least six other states have property tax relief legislation pending; Antitax activists in Nevada and Idaho have long sought a system patterned on Proposition 13, and New York’s governor has called for a new cap on property tax increases for most school districts.

It is easy to see why assessment limits are among the most popular relief measures offered in response to rapidly rising tax bills. When values rise quickly and not uniformly, some taxpayers will face dramatic tax changes in a short period of time. Because rising values are seen as the cause of this problem, limits on assessment increases are expected to offer homeowners predictability and

stability in their taxes. Assessment limits are currently in place in 19 states and the District of Columbia (referred to here as 20 states). The details of these programs vary from state to state, but their most common element limits annual increases in assessed value to a specified percentage of the prior year’s figure.

PROPERTY TAX RELIEF IN DECLINING MARKETS

The connection between rising property values, increased assessments, and higher property taxes seems so self-evident that many observers are surprised when calls for tax relief persist even in declining property markets. In fact, the root causes of rising tax bills—increases in government spending and shifts in tax liabilities across properties—can occur in either a rising or a declining market. The drop in housing values in 2007–2008 has not quelled pressure for tax relief. Although 2007 saw a 14 percent one-year drop in home prices, one of the steepest



CHAPTER 2

Assessment Limits: Basic Elements

Assessment limits generally restrict the annual increase in assessed value to a specified percentage of the previous year's figure. The limits currently in use vary according to the amount of increase permitted, the application of the limit to individual parcels or to the aggregate value of taxable property in the jurisdiction, the type of property to which the limit applies, and the legal basis for the limit. Table 1 identifies the 20 states with assessment limits and summarizes their programs.

SETTING THE LIMIT

Most limits restrict annual growth in assessed value to either a fixed percentage or a measure of inflation such as the Consumer Price Index. California's statewide assessment growth limit remains the lowest at 2 percent. Florida, Oregon, and New Mexico allow a

maximum of 3 percent annual growth in assessed value; and South Carolina restricts increases to a maximum of 15 percent over five years. Iowa limits increases in assessed valuation to 4 percent; and Arkansas, Michigan, and Oklahoma all have 5 percent caps. Limits in New York City range from 6 to 8 percent per year, while Cook County, Illinois has a 7 percent limit. Limits of 10 percent are in effect in Arizona, the District of Columbia, Maryland, and Texas. The highest limit, in Minnesota, is 15 percent. Colorado has a unique system that limits the residential portion of the tax base to 45 percent of the total tax base.

In the District of Columbia, the Assessment Cap Credit program replaced a system of triennial reassessments phased in over three years. Properties are now reassessed annually, and any increase in homestead

Residences in Chicago are subject to the 7 percent assessment limit in Cook County, Illinois.





TABLE 1
Characteristics of Property Tax Assessment Limits by State, 2007

State	Coverage	Eligible Property	Caps Removed upon Sale?	Individual Parcel Value or Aggregate Assessment?	Limits and Qualifications
Arizona	statewide	all	no	individual	greater of 10% or 25% of difference between last year's limited value and current market value
Arkansas	statewide (constitutional)	all	yes	individual	homestead 5%, other 10%
California	statewide (constitutional)	all	yes	individual	lesser of 2% or inflation
Colorado	statewide (constitutional)	residential	N/A	statewide aggregate	residential assessments limited to 45% of state total
Connecticut	local option	all	N/A	individual	phase-in, at least 25% per year
District of Columbia	district-wide	homestead	yes	individual	10%; 5% for qualifying low income
Florida	statewide (constitutional)	homestead	yes	individual	lesser of 3% or inflation
Georgia	local option (local constitutional)	homestead	yes	individual	freeze (0%)
Illinois	local option	homestead	yes	individual	7% with maximum exemption value of \$33,000
Iowa	statewide	residential and agricultural	no	statewide aggregate	4%
Maryland	statewide	homestead	yes	individual	10% statewide for state property taxes; local options for local taxes range from 0% to 10%
Michigan	statewide (constitutional)	all	yes	individual	lesser of 5% or inflation
Minnesota	statewide	farm, residential, seasonal residential	no	individual	greater of 15% or 33% of difference between last year's limited value and current market value
Montana	statewide	all	yes	individual	16.66%/yr phase-in of reassessment over 6 years
New Mexico	statewide	residential	yes	individual	3%
New York	New York City & Nassau County	residential with 10 or fewer units	yes	individual	6% (residential up to three units) or 8% (other residential) per year; 20% or 30% over 5 years
Oklahoma	statewide (constitutional)	all	yes	individual	5%
Oregon	statewide (constitutional)	all	no	individual	3%
South Carolina	statewide (constitutional)	homestead	yes	individual	15% over 5 years
Texas	statewide (constitutional)	homestead	yes	individual	10%

Sources: Anderson (2006), Sexton (2003), and various state Web sites.

Arizona homes, like these in Phoenix, have a complex assessment limit program that requires two separate values.



(owner-occupied residential) assessments above 10 percent results in an automatic credit for the amount of tax on the excess value. The cap was originally set at 25 percent in 2002, reduced to 12 percent in 2003, and to 10 percent in 2004 (Bowman 2006).

Arizona and Minnesota are among the states with the highest limits, and both have very complex programs. In Arizona, each parcel of property has two separate values: a fair market value (FMV) and a limited property value (LPV). The FMV is used to determine taxes for special districts, fire districts, school districts, bond issues, and bond overrides, while LPV is the basis for taxes owed to counties, cities, towns, and community college districts. The annual increase in a property's LPV is limited to the greater of 10 percent or 25 percent of the difference between the previous year LPV and the current FMV.

Minnesota enacted a similar program in 1993. Under the state's limited market value (LMV) law, increases in assessments of farms, residential property, seasonal recreational

residential property (cabins), and timberland are limited to the greater of 15 percent of the prior year's taxable value or 50 percent of the difference between the current estimated market value and the prior year's value (the difference factor). The limit applies to owner-occupied and rental housing with three or fewer units. A change in ownership does not affect the assessment limitations. Increases in value due to new construction and improvements are not subject to the limit. The difference factor, and therefore the tax limit, has increased in each of the past three years, from 25 percent in 2006 to 33 percent in 2007 and 50 percent in 2008. The program is scheduled to end with taxes payable in 2009.

Connecticut, Maryland, and Montana phase in assessment increases over a multi-year period. Maryland has a three-year reassessment cycle in which one-third of any value increase is added each year. State property taxes are subject to a 10 percent annual assessment limit, and local governments may impose a lower ceiling for local

taxes. For fiscal year 2007, 15 of the 24 Maryland counties set limits below 10 percent. Talbot County allows no increase in homeowner assessments, and Anne Arundel County has a 2 percent limit. Seven counties have established 5 percent limits, and nine counties maintain the maximum allowable 10 percent limit.

Local governments in Connecticut, with a five-year reappraisal cycle, have a similar option to raise assessed values gradually over the cycle, although they must phase in the increases at a rate of at least 25 percent per year.

An assessment freeze—an extreme version of an assessment limit—prevents any increase in assessed values from year to year until the property is sold. Georgia allows counties this option, and 19 of its 159 counties have chosen to freeze residential values. Delayed or infrequent reassessments can have the same effect as an interim freeze between revaluations. Twenty-seven states

do not require annual reassessment and thereby impose an implicit assessment limit of zero percent if no inflation adjustments are made to assessed valuations in non-reassessment years.

DETERMINING ELIGIBILITY

Most states limit assessment increases for individual parcels, but these limits can also apply to aggregate assessments by property type across jurisdictions or across the entire state, as in the case of Iowa. Even though Iowa limits annual assessment increases to a relatively low 4 percent, its limit is among the least restrictive because it is applied statewide to entire classes of properties (residential, agricultural, and commercial) rather than to individual parcels. If the increase in the total assessed value of a class of property exceeds 4 percent, all assessments in that class are reduced proportionally. Because properties of the same class can experience significant differences in appreciation, a limit



Vacation homes in the Colorado mountains are part of the state's unique assessment system.



Apartment buildings in New York City have different assessment limits depending on the number of units.

on class valuations will not prevent large increases in individual assessments.

Since 1982 Colorado's Gallagher Amendment has required that the residential portion of the statewide property tax base not exceed 45 percent. The assessment ratio for residential property fluctuates in order to maintain its 45 percent share of the total. In this way increases in residential assessments are essentially limited to the rate of increase in nonresidential property values.

Assessment limits may apply to all types of property or to only certain classes. Some states have established different limits for different types of property, but all 20 states

in this analysis have some form of assessment limit for homestead property. In the District of Columbia, Florida, Maryland, South Carolina, and Texas, only homestead assessments are limited, while other states, such as New Mexico, include all classes of residential property. Still others, including Arizona, California, Connecticut, Michigan, Montana, Oklahoma, and Oregon, limit assessment increases for all property types.

When limits apply to more than one class of property, the rate of permitted increase may vary among them. For example, Arkansas applies a 5 percent limit to homestead properties and a 10 percent limit to other types of property. In New York City the assessed values of one- to three-unit residential properties cannot increase by more than 6 percent in one year and 20 percent over five years. For four- to ten-unit properties, assessments may not increase by more than 8 percent in one year and 30 percent over five years. For all other residential and commercial properties, assessment changes are phased in over five years.

Taking a different approach to eligibility, some states restrict assessment limits to certain categories of property owners, such as elderly or low-income taxpayers. At least 12 states have some form of assessment freeze in effect for senior homeowners, and five extend this to disabled taxpayers (Rappa 2003). Most states that target property tax relief to seniors set income as well as age criteria for eligibility.

ACQUISITION VALUE AND ALTERNATIVES

Assessment limits usually include an acquisition value feature that resets the assessed value to reflect market value upon a change in ownership. Of the 18 states that apply their assessment limit to individual parcels, only Arizona, Minnesota, and Oregon do not have this acquisition value feature.

Oregon presents an interesting exception in this regard. The state's Measure 50, passed in 1997, was similar to California's Proposition 13 in that it rolled back assessments to 90 percent of 1995–1996 values and generally restricted future annual growth to no more than 3 percent. Oregon does not adjust assessments upon change in ownership, nor does it assess new construction or improvements at market value. Instead, new construction and improvements are assessed at the same ratio of assessed value to market value as similar existing property, thus providing new property with the same tax relief as existing property. With no periodic recalibration of assessed values to market levels, the Oregon system has gone the farthest of any in breaking the link between property taxes and property values.

COVERAGE AND LEGAL AUTHORITY

Assessment limits in 16 states are statewide and uniform in their coverage. Among the four exceptions, Connecticut, Georgia, and Illinois make limits available as a local option, and New York mandates limits only in New York City and Nassau County.

In 2003 Illinois permitted counties to impose a 7 percent limit on annual increases in homestead property assessments. Cook County immediately implemented such a limit for taxes payable in 2004. Illinois is unique in setting a maximum value (originally \$20,000, later increased to \$33,000) that can be excluded from taxation. The Illinois law is also unusual as a temporary measure, first enacted for a three-year period, and then extended for three more years. As noted above, Minnesota's limited market value legislation is set to expire in 2009.

In ten states assessment limits were enacted as constitutional amendments (see table 1, Coverage) and require voter approval for

TABLE 2
Property Tax Limitations by State

State	Assessment Limits	Revenue Limits	Tax Rate Limits
Arizona	X	X	X
Arkansas	X	X	X
California	X		X
Colorado	X	X	X
Connecticut	X		
District of Columbia	X		
Florida	X		X
Georgia	X		X
Illinois	X	X	X
Iowa	X		X
Maryland	X		
Michigan	X	X	X
Minnesota	X	X	
Montana	X	X	X
New Mexico	X	X	X
New York	X		X
Oklahoma	X		X
Oregon	X		X
South Carolina	X		
Texas	X	X	X

Source: Anderson (2006, 688).

any change. The other ten states have legislative limits that can be revised without voter approval.

Sixteen of the 20 states with assessment limits also have limited growth in property tax revenue or have capped property tax rates (see table 2). Eight states have assessment limits, revenue limits, and tax rate caps; seven have assessment limits and rate caps; and one has an assessment and a revenue limit. Connecticut, the District of Columbia, Maryland, and South Carolina have no explicit rate or revenue limits.



CHAPTER 3

Impacts on Local Governments

Property tax systems are established by state legislation, yet the overwhelming majority of property tax revenue supports local government. Assessment limits thus represent a restriction by one level of government, the state, on the funds available to another, local jurisdictions. This reduction in a significant source of local revenue must be addressed by some combination of alternate revenue sources, state aid, and spending cuts.

EROSION OF THE PROPERTY TAX BASE

By definition, assessment limits only restrict assessed values when property appreciation exceeds a specified level. The limit will reduce the property tax base for communities experiencing price increases above that threshold. The lower the limit, the greater the erosion of the tax base. If property values are stable or declining, the assessment limit will not reduce the tax base.

If assessed values are reset at fair market levels at the time of sale, property turnover will mitigate the reduction in the tax base. In the extreme, if every property eligible for the limit were sold each year, the limit would have no effect on the tax base. Since new construction is usually put on the tax rolls at fair market value, the tax base of a growing jurisdiction can increase by more than the assessment limit.

It can be difficult to measure the loss in taxable value caused by assessment limits, because jurisdictions may not calculate what the taxable values would have been in their absence. For example, California assessors no longer have any incentive to maintain a record of the market value of property. Under Proposition 13, this information is

only relevant in a year in which a property is sold or in which market values drop below the adjusted acquisition value. At other times, assessed values are determined by increasing the previous year's value by 2 percent (or the rate of inflation, if lower).

A comprehensive study of the effects of Proposition 13 compared the assessed value and market value of a sample of properties sold in 1992 (O'Sullivan, Sexton, and Sheffrin 1995a). The study found that total assessed value was approximately 56 percent of market value—i.e., Proposition 13's 2 percent assessment reduced the tax base by 44 percent that year, from \$2.9 trillion to \$1.6 trillion.

The Texas Association of Property Tax Professionals estimated that Texas's 1997 constitutional limit of 10 percent on annual residential homestead assessment increases reduced the tax base by \$1.9 billion in 1998, \$14.2 billion in 2002 and \$10.9 billion in 2003 (Moak, Casey & Associates 2004). Similarly, an analysis of homestead assessments in Muscogee County, Georgia, found an annual tax base loss of up to nearly 10 percent between 1985 and 1997 (see box 2).

Several studies have examined the effects of Florida's Save Our Homes 3 percent assessment cap. Hawkins (2006) reported that by 2004 the tax base loss (the differential between the market value and assessed value) of Florida homestead properties had grown to more than \$160 billion. A University of Florida (2007) study reported a difference of \$398 billion in 2006, more than 17 percent of the market value of all property that year. Although Minnesota's 15 percent assessment limit is considerably higher than California's 2 percent

Assessment Freeze in Muscogee County, Georgia

In 1983 Georgia permitted counties to freeze locally assessed homestead values, reassessing only upon a change in ownership or new construction. Since the freeze applies only to local (city, county, and school district) property taxes, and not to the state property tax, the county must maintain two values for each homestead—acquisition value and fair market value. With access to both values for Muscogee County, Sjoquist and Pandey (2001) were able to analyze the effects of the freeze on the property tax base, assessment equity, and household mobility.

Effects on the Tax Base

- Between 1985 and 1988 the freeze reduced the local assessed values by less than 3.5 percent because market values were fairly stable during that period.
- In 1989 a mass revaluation changed state assessments dramatically, resulting in a 9.9 percent difference (between \$165 and \$200 million) in the state and local tax bases.
- By 1997 the difference between the state and local residential tax base was 15.2 percent. The difference between total state and local tax bases was only 5.9 percent, however, because of rapid growth in nonresidential values.

Assessment Inequities

- A house purchased in 1997 had, on average, a local assessed value 67 percent higher than an equivalent house purchased in 1983.
- The average reduction in assessed value due to the freeze was much larger for higher-valued properties than for lower-valued properties, when measured in absolute dollar terms. However, as a percentage of state assessed value, the percentage tended to decline as value increased. Lower-valued properties save less in dollars but more in percentage terms. Some lower-valued homes have had their local assessed values reduced more than 80 percent.

Household Mobility

- 1997 residential sales data did not provide statistically significant evidence of a lock-in effect discouraging taxpayers from moving.



**Historic houses
in Columbus, the
county seat of
Muscogee County.**

or Florida's 3 percent, the Minnesota Revenue Department (2006) reported a \$32.5 billion or 7 percent reduction in the tax base statewide for taxes payable in 2006.

EFFECTS ON GOVERNMENT REVENUES

By themselves, assessment limits need not reduce overall property tax revenue if jurisdictions can increase the tax rate to make up for the lost base. This is not possible, however, if tax rates are also limited, as is the case in

15 of the 20 states with assessment limits.

The impacts of Proposition 13 have been particularly complex and have elicited diverse citizen reactions (see figure 6). Proposition 13 rolled back assessed values and lowered the total property tax rate from an average of 2.5 percent to 1 percent. As a consequence, California property tax revenue fell from \$10.3 billion in fiscal 1977–1978 to \$5.6 billion in 1978–1979, a decline of over 45 percent. Counties were hit hardest, experiencing a 57 percent decline in

FIGURE 6
Point/Counterpoint on California's Proposition 13

Howard Jarvis, the leader of California's most famous tax revolt, passed away in 1986. But in the spring and summer of 2007 his name continually popped up in newspaper articles across the United States. Property tax troubles were brewing throughout the country and Jarvis's prodigy, property tax-cutting Proposition 13, was remembered by beleaguered taxpayers as something to be emulated to protect against out-of-control levels of taxation.

Meanwhile, 29 years after California's tax revolt, things were pretty quiet on the property tax front in the Golden State. Proposition 13 still has its opponents and critics, but after nearly three decades, voters generally think the tax-cutting measure worked just fine. [Public Policy Institute of California Surveys: February 2003, May 2005]

California taxpayers enjoy a sense of certainty and security knowing what their property taxes will be year-to-year. As California tax historian David Doerr [2000] has written, "Proposition 13 removed the fear that future taxes would be controlled by an inflated value, representing unrealized *paper gains*, and based on activity in the real estate market and other economic factors over which the taxpayer had no control." (Fox 2007)

In 1936, in the depths of the Depression, a new school went up in San Francisco's Mission District... It was designed as a beautiful and welcoming place for students who would otherwise have been marginalized in the larger public school system. Today, because of the Proposition 13 tax limit measure, building such a school—or providing any basic need, for that matter—has become amazingly difficult. And California is not the better for it.

Proposition 13—approved by the voters in 1978—and subsequent tax-limit measures have made responsible fiscal planning impossible at the state level. By shrinking revenue from property taxes, Prop. 13 has distorted local government financing and land-use planning. Instead, local governments must rely on sales tax-generating shopping malls and housing sprawl tied to developer fees. Meanwhile, the state, which had helped cash-strapped local governments and school districts deal with Prop. 13, now faces its own fiscal crisis. (Holt 2008)



property tax revenues. School district taxes fell from \$4.2 billion in 1977–1978 to \$2.0 billion in 1978–1979, and then to \$1.6 billion in 1979–1980, a 61 percent decrease over a two-year period.

Enterprise special districts that provide services such as utilities, transportation, sewers, and waste removal experienced a 27 percent reduction in property tax revenues from 1977–1978 to 1978–1979. Nonenterprise special districts such as parks, libraries, police, and fire protection districts experienced a 52 percent reduction in property tax revenues over the same period (California State Controller, various years).

Citizens who seek relief from rising tax bills or sudden changes in assessments may not necessarily favor reductions in local services or new fees to maintain those services. For example, the special political background to Proposition 13 included a multi-billion-

dollar state surplus that voters correctly perceived as affording an initial cushion against local revenue loss. As a result, many important cuts in public services were delayed. Conversely, if increased local taxes are the result of cuts in state aid, limits on local revenue may be an inappropriate response. Statewide legislation restricting local revenue can also have the unintended effect of penalizing frugal jurisdictions whose future spending may be capped at an unreasonably low level.

Predictions of the revenue consequences of assessment limits face the same uncertainties as predictions of their effect on the tax base. Hawkins (2006) calculated that 2004 school and county property tax revenues in Florida were \$1.82 billion or 10.6 percent lower than they would have been without the assessment limit (see box 3). The statewide limit on local revenue increases

San Francisco has a variety of housing types, all of which are subject to the Proposition 13 tax limits.

Florida's Save Our Homes Assessment Limit

Florida's 1992 Save Our Homes constitutional amendment limits the annual increase in the assessed value of owner-occupied (homestead) residences to 3 percent or the annual inflation rate, whichever is lower. In addition, all properties are to be reassessed at market value following a change in ownership and no assessment may exceed market value.

An examination of county- and property-specific tax data to determine the measure's effects reports that in January 2006 the assessed value (Save Our Homes value) of homestead property (\$644 billion) was 62 percent of its market value (\$1.042 trillion) (University of Florida 2007). This \$398 billion dollar reduction in the property tax base constitutes almost 17 percent of market value statewide and translates into an almost \$8 billion reduction in tax revenue, assuming a 2 percent tax rate.

Significant variations in these impacts were found across cities and counties. The effect on local property tax revenues varied with the rate of appreciation in housing prices, the percentage of properties that are homesteads, the frequency of sales (turnover), new construction activity, and the tax rate. Counties most affected by the assessment limit were high-value, higher-income suburban counties and high-growth, high-appreciation coastal counties. The study also found substantial variation in the differences between Save Our Homes assessed values and market values of individual properties.

Concern that the lock-in effect of the assessment limit has trapped Floridians in their current residences, and complaints



in Illinois forced most local governments to reduce their tax rates in response to rising assessed values, even before implementation of the 7 percent assessment cap in Cook County. The use of the assessment cap subsequently reduced the amount by which the tax rate dropped.

REDUCTION IN LOCAL GOVERNMENT AUTONOMY

Assessment limits may have profound implications for local control over spending decisions. The property tax has historically

been a primary fiscal tool of local governments and a major source of their discretionary revenue. Many localities have been able to adjust their budgets and allocate resources according to community preferences through their control of property tax revenues. Assessment limits and tax rate limits can severely restrict local revenue, requiring services to be cut or alternative revenue sources found. If local governments seek support through increased state aid, they often face greater state control and a loss of local autonomy.



of discrimination against nonresident homeowners, led to several property tax reform proposals in 2007. They included raising the assessment limit from 3 percent to 6 percent, and gradually phasing out the limit and substituting a larger homestead exemption based on the median assessed value in the county or a tiered exemption based on the value of the property. By approving Amendment 1 in January 2008, voters decided not to eliminate the assessment limit, but rather to extend its reach.

Amendment 1 allows full-time Florida homeowners to take their Save Our Homes tax benefits with them when they move. They can transfer up to \$500,000 of their assessed value savings on their old house and apply it to the assessed value of their new home. In addition to allowing Save Our Homes portability, Amendment 1 doubled the \$25,000 homestead exemption for all but school property taxes, and established a separate assessment limit of 10 percent for nonhomestead properties.

Some legal experts have expressed doubts as to whether the new portability feature will withstand a constitutional challenge. The U.S. Constitution's "right to travel" provision guarantees that a citizen who moves from one state to another is treated the same as other residents in his or her new state. Portability may be found to violate this provision because it gives in-state homebuyers an advantage over those who have recently arrived in the state.

The recent downturn in the housing market has not eliminated pressure for property tax reform in Florida. Instead, homeowners are incensed to find their property tax bills increasing while the values of their homes are falling. The Save Our Homes "recapture rule" means that many homeowners' taxable values will rise even if market values fall, as long as a home's market value remains above its taxable value. Market value can decline, but taxable value still increases 3 percent (or the inflation rate). A home's taxable value increases until it catches up with market value.

The same feature can be found in California's Proposition 13, although the tax rate there is capped at 1 percent, while in Florida local governments can raise tax rates. However, new limits on local revenue growth may prevent any Florida jurisdictions from increasing their tax rates in the future.

Theoretically, "no strings" state aid could replace lost property tax revenue without impeding local decision making and marginal spending choices. However, state funding generally increases the centralization of power, as has been seen most dramatically in the California public school system. Similarly, local override options may allow taxpayers to choose to relax revenue limits, but the degree to which this is possible in practice depends on their specific provisions.

When multiple overlapping districts have taxing authority, overall rate limits require

an allocation of tax shares among participating governments. State allocation of revenue among these units of government may differ dramatically from the preferences of local voters, and is unlikely to respond to changes in local needs. California's basic apportionment formulas date back to 1979 and reflect the relative distribution of tax revenues at that time. Local finances there are now heavily influenced by state decisions, subject to increased uncertainty, and dominated by interjurisdictional competition for sales tax revenues.



CHAPTER 4

Equity and Efficiency

The popularity of assessment limits is due, in part, to the perception that they will prevent sudden increases in property tax bills and correct inequities in the distribution of the tax. Voters fear that the elderly, especially those on fixed incomes, will be forced from their homes, and that homeowners in general will shoulder an unfair share of the tax burden compared to commercial and industrial property owners. In reality, assessment limits do alter the distribution of property taxes, but not always as intended. They may cause similarly situated taxpayers to bear very different tax burdens. In addition, an acquisition value system discourages households from moving. This distorts economic decision making and reduces welfare through an inefficient allocation of resources.

REDISTRIBUTING THE TAX BURDEN

Nonuniform increases in values shift the tax burden to more rapidly appreciating properties. Assessment limits may or may not prevent this shift, depending on what types of property are affected and whether property value is reset upon a change in ownership. An acquisition value system can shift the property tax burden toward properties with the highest turnover, regardless of which class is experiencing the greatest appreciation. This has been the case in California.

When residential property assessments are capped but tax rates are not, some taxpayers, including homeowners, may see their bills rise to maintain the same level of government spending. Because the cap will reduce the tax base, a revenue-neutral response will raise the tax rate. Nonresidential properties, slowly appreciating residen-

tial properties, and even some residential properties with appreciation above but near the cap will end up paying higher taxes than they would without the cap.

The tax burden is thus shifted from protected properties to those that are not eligible for the limit, and from limited properties with rapid appreciation to those with slower growth or no appreciation. Even some protected properties whose appreciation is above the limit, and appear to benefit from the limit, actually pay higher taxes because of it. Recent studies have identified this type of redistribution in Minnesota (see box 4) and Cook County, Illinois (see box 5).

Idaho has long considered a property tax limit modeled on Proposition 13, and dramatic increases in property values there have reignited debate on assessment limits. Dornfest (2005) explored the impact of hypothetical residential assessment limits, ranging from 2 to 8 percent, in two of the largest counties in Idaho. In Kootenai County, 86 to 88 percent of the more than 33,000 residential parcels analyzed would have lower taxable values as a result of any of such caps, but more than 50 percent of these parcels would pay higher taxes because of the need to raise the tax rate in order to maintain revenue. Overall, 60 percent of the parcels studied in Kootenai County would pay higher taxes under the assessment limit.

In Ada County, where values have not increased as rapidly, a smaller proportion of properties would gain or lose from an assessment cap. Of the more than 98,000 parcels examined, 28 percent would not experience a change in tax as a result of the limit. The percentage of parcels whose taxes would increase varied from 25 percent with a 1 or 2 percent cap to 76 percent with an 8 percent

Minnesota's Limited Market Value

Assessment limits can increase property taxes even for owners whose taxable values are reduced, as Minnesota's experience shows. The state's limited market value (LMV) program restricts growth in assessments of farmland, homesteads, timberland, and seasonal recreational property. In 2005 approximately \$33 billion in property value statewide was taken off the tax rolls because of LMV.

LMV is intended to shield appreciating properties from rapid property tax increases. But in practice it shifts the property tax burden from homes and farms that are appreciating rapidly to those whose values are growing at a slower rate or are declining, and to properties that are not subject to LMV, such as apartments and commercial and industrial properties. Until recently no one really knew who was benefiting from the LMV subsidies, or who was being hurt.

A report by the Minnesota Department of Revenue (2006) compared actual property taxes with the property taxes that would have been paid if LMV did not exist. It found that in 2006 the state's LMV law actually increased property taxes for 78 percent of homeowners by \$106 million or an average of \$96 per parcel. Property taxes decreased for the other 22 percent of homeowners by \$86 million, an average of \$273 per parcel. Sixteen percent of the properties that experienced tax increases actually had their assessments reduced, but paid higher taxes because the increased tax rate more than offset their comparatively small reductions in assessed value. These homeowners saw that LMV decreased their assessments, and concluded that it was providing them with tax relief. However, their taxes would have been lower without LMV.

Seasonal recreational residential property in Minnesota received the largest value reductions (22.7 percent statewide), while homestead property was reduced the least, only 4.5 percent. In terms of tax dollars, the owners of farm homestead property were the chief beneficiaries, enjoying a reduction in tax burden of \$25.6 million, while the commercial and industrial property tax burden increased by \$51.5 million.





In 2004 Illinois permitted counties to impose a 7 percent limit on annual increases in the assessed value of homestead properties. This limit was unique in that it did not exempt all value above the threshold from taxation. Instead, it removed all or a portion of the increase above 7 percent from the tax base by allowing the homestead exemption to vary from \$5,000 to a maximum of \$20,000, later increased to \$33,000. If a property's value rises by more than that amount, the excess is included in its assessment. According to the Cook County Assessor's Office, the median increase in assessments in Chicago had been almost 32 percent from 2002 to 2003.

Believing that the new law would provide much needed tax relief and bring predictability to property tax bills, Cook County immediately implemented the assessment cap. An analysis of the economic effects of the 7 percent assessment cap, estimating the 2003 and 2004 property tax payments on each Cook County parcel with and without the cap, includes the following findings (Dye, McMillen, and Merriman 2006a; 2006b):

- Seventy-five percent of eligible Chicago homeowners benefited from the assessment cap, saving an average of 14.2 percent in the first year. In some areas tax payments fell by 30, 40 or even 50 percent in 2003.
- The effects varied across housing value classes. The gains from the assessment limit decreased as property value increased, with the greatest benefits going to low- and mid-value properties.
- Commercial properties absorbed the largest share of the resulting shift of the tax burden. Eligible homestead properties in Chicago paid \$128 million less in 2003, but ineligible residential properties paid \$30 million more, apartments \$14 million more, and commercial properties \$60 million more.
- To compensate for the fall in the tax base, tax rates throughout Cook County increased. The Cook County tax rate rose 4.5 percent in 2005, and school districts increased their tax rates an average of 5 percent. Chicago and its suburbs saw tax rate increases between 4.1 and 6.6 percent.
- Some homeowners whose properties appreciated more than 7 percent and who therefore saw their assessed values reduced still paid higher taxes than they would have in the absence of a cap, because of the rise in tax rates.
- Citizens eligible for the more advantageous "senior freeze" on assessments ended up with higher tax bills. Their property values were already frozen, so they did not benefit from the cap, but they were subject to the resulting higher rates.



cap. As many as 38 percent of all properties whose values would be limited with a 3 percent cap would pay higher taxes because of it.

In most of the situations considered by Dornfest, the break-even point for property tax relief was above the actual assessment cap. For example, in Ada County a 6 percent value increase cap would result in lower taxes only for parcels with assessed value increases greater than 7 percent, an effect that becomes more pronounced as the cap is lowered. With a 1 percent annual value increase cap, only properties with value increases in excess of 4 percent would experience lower taxes.

Dye and McMillen (2007a and 2007b) also studied the distributional effects of assessment limits. Their model confirmed that properties whose assessments are reduced by the limit may actually face increased taxes as a result. The likelihood and magnitude of this effect increase with the overall appreciation rate of eligible properties and the proportion of eligible properties with high appreciation rates. Again, assessment limits shift the tax burden from eligible to ineligible properties, and among eligible properties from those with high rates of appreciation to those appreciating more slowly or not at all.

Tax shifts among income groups are not easy to predict. While it is true that high-income households are more likely to be homeowners and generally own larger and more valuable residences, these homes might not experience the most rapid appreciation. For example, California's relative shortage of entry-level homes, caused in part by the lock-in effect of Proposition 13, has resulted in higher rates of inflation for smaller, less expensive residences. Higher-income households tend to be more mobile, so higher-valued properties may change hands more frequently and be reset to market value more often. Dingemans and Munn (1989) found that from 1978 to 1985, property owners in the more expensive neighborhoods

of Davis, California, received the greatest benefits from Proposition 13, but by 1985 to 1988, those same neighborhoods experienced the largest increases in taxes because of increased home sales.

If assessment limits are accompanied by rate limits, local governments cannot necessarily raise the tax rate enough to maintain tax collections. Some increase may be possible, and even without a change in rate the adjustments to assessed values will redistribute the tax burden from limited properties to those that are not covered by the assessment limit. If the tax rate is unchanged and assessments are capped, all eligible properties with appreciation above the limit will benefit from lower taxes.

A popular misconception assumes that the tax distribution will not change over time if a low assessment cap is accompanied by a rate cap and applies to all property in the jurisdiction. However, an acquisition value system puts residential properties at a tax disadvantage because homes typically change ownership more frequently than do businesses. If the assessment limit applies to all types of property, the burden will shift toward residential property as its aggregate assessed value increases more rapidly due to turnover.

California has experienced a dramatic tax shift from commercial to residential properties since Proposition 13, largely due to differential turnover rates. The homestead percentage of total assessed value in the state increased from 32 percent in 1979–1980, immediately after Proposition 13, to nearly 40 percent in 2005–2006 (Research and Statistics Section, California State Board of Equalization). This shift has been even more pronounced in some counties, even those with vibrant business growth. Santa Clara County is considered the center of Silicon Valley because it contains the headquarters of Apple, Cisco, Hewlett Packard,

Similar houses in California's San Fernando Valley may have very different assessed values depending on their turnover rates.



Intel, IBM, Google, Yahoo, and many other high-tech firms. In 1977–1978, single-family residential properties and condominiums accounted for 50 percent of the property tax base there. Today that share is over 69 percent (Santa Clara County Assessor 2007).

HORIZONTAL INEQUITIES

As noted above, all states that impose assessment limits on individual properties, with the exception of Arizona, Minnesota, and Oregon, have acquisition value features that reset assessments upon a change in ownership. Together with the assessment limit, this policy creates large disparities in property tax bills and effective property tax rates (the percentage of full market value represented by the tax bill) among owners of comparable properties. Horizontal equity—the idea that taxpayers in similar situations should face similar tax burdens—is a core principle of sound tax policy. Acquisition value systems abandon this principle by taxing long-time owners less than new owners of similarly valued properties.

Under an acquisition value tax system, horizontal inequities among property owners are inevitable. When a property is sold, it is assessed at market value, but assessed value will be less than market value in the future if the property appreciates at a rate greater than the permitted ceiling. That gap will grow over time if appreciation continues to outpace the annual assessment limit. The sale of a property triggers reassessment at its full market value, so households in identical dwellings will face different tax liabilities, with a recent buyer paying higher taxes than an owner who has remained in the same dwelling for some time (see box 6).

These disparities, and their subsidy for established homeowners, can distort the tax price of local services—the amount that voters perceive as their cost. This in turn distorts voter decision making, causing established residents to demand more local services and amenities than they would be willing to pay for if they faced a tax price that reflected their proportionate share of the actual cost.



Financier Warren Buffett (2003) used his own property taxes to illustrate the inequities resulting from California’s acquisition value system. He explained that he paid \$2,264 in property taxes in 2003 for a home he purchased in the 1970s. In 2003 that property was worth \$4 million. He purchased a second house in the same neighborhood in the mid-1990s. The second house was worth roughly half the value of the first, but his 2003 property tax bill on the second house was \$12,002. The effective tax rate on the

second house (0.6 percent) was 10 times higher than that on the first (0.056 percent).

Documenting these kinds of disparities, O’Sullivan, Sexton, and Sheffrin (1995a) found that California homeowners who had resided in their current homes in Los Angeles County from 1975 to 1991 (a group that constituted 43 percent of all county homeowners) were, on average, underassessed relative to market value by a factor of five. This meant that actual market value had increased to a level five times

BOX 6
Example of Horizontal Inequities Created by an Acquisition Value System

Imagine three identical California houses that each sold for \$100,000 in 1975 (see table 3). After Proposition 13 their 1978 assessed values were set at their 1975 market values of \$100,000. Assume that their market values have increased 7 percent per year since 1975. House A has not been sold since 1975, House B sold in 1990, and House C sold in 2005. Table 3 illustrates what has happened to the market and assessed values of each of these properties, and compares their 2005 property taxes and effective tax rates under an acquisition value system with a maximum 2 percent annual increase.

In 1990 and 2005, market values of all three houses are identical and reflect the 7 percent annual appreciation since 1975. The 1990 assessed values differ because when House B is sold its assessed value is set at its new 1990 market value. Houses A and C have the same assessed values in 1990, with a 2 percent increase each year since 1978. In 2005, the assessed values of all three houses differ. House A’s 1990 assessed value continues to grow at 2 percent per year. House B’s 2005 assessed value represents 2 percent annual growth in its 1990 assessed value. The assessed value for House C is reset to its 2005 market value when it sells in 2005.

The disparity ratios, which measure the proportion of market value to assessed value, vary from 1.00 to 4.46 in 2005. The stated 2005 tax rate is 1 percent, but the effective tax rate, the ratio of the tax bill to market value, varies from 0.22 percent to 1 percent. House A, which has not sold since 1975, has the highest disparity ratio, the lowest tax, and the lowest effective tax rate. These properties face very different tax obligations simply because of when they were last sold.

House	1975 Market Value	1978 Assessed Value	1990 Market Value	1990 Assessed Value	2005 Market Value	2005 Assessed Value	2005 Disparity Ratio	2005 Tax	2005 Effective Tax Rate
A	\$100,000	\$100,000	\$275,903	\$126,824	\$761,226	\$170,689	4.46	\$1,707	0.22%
B	\$100,000	\$100,000	\$275,903	\$275,903	\$761,226	\$371,329	2.05	\$3,713	0.49%
C	\$100,000	\$100,000	\$275,903	\$126,824	\$761,226	\$761,226	1.00	\$7,612	1.00%

that of assessed value, and that the property taxes due on two identical homes would differ on average by a factor of five if one of the homes were to sell. The authors show that the primary beneficiaries in California have been lower-income and senior homeowners, because they move less frequently than other groups.

In the long run, differences in turnover rates and appreciation above the assessment limit are the primary sources of inequity in an acquisition value system. Disparity ratios (the proportion of market value to assessed value) change over time; they tend to increase as property values rise but decrease with property sales. In Los Angeles County, the percentage of properties with 1975 base years decreased from 43 percent in 1992 to 30 percent in 1996 due to natural turnover.

The recession of the early 1990s led to a nearly 30 percent drop in property values in southern California, and the median disparity ratio for properties with a 1975 base year decreased from 5.19 to less than 4.0. Thus, both natural turnover and the recession diminished property tax disparities between 1992 and 1996 (Sheffrin and Sexton 1998). The impacts of the subsequent housing boom and the more recent price deflation on these disparities are unknown. While rapidly rising property values would tend to increase the disparities, increased turnover would have the opposite effect (see box 7).

The assessment freeze in Muscogee County, Georgia, created significant assessment disparities among homeowners (Sjoquist and Pandey 2001). The average dollar reduction in assessed value was found to increase with household income although the percentage reduction dropped as income rose (see box 2, page 17).

Hawkins (2006) noted similar horizontal inequities among Florida homeowners, citing two Siesta Key neighbors who owned vir-

tually identical condominium units, but paid widely different property taxes (\$2,300 and \$5,700, respectively) because one property was purchased more recently than the other. Seasonal homeowners are at a particular disadvantage because they do not qualify for the state's Save Our Homes assessment limit. They therefore pay higher property taxes than permanent residents, while at the same time consuming fewer local services. A group of Alabama residents with second homes in Florida brought a legal action to overturn the assessment cap there as an unfair burden on "snowbirds" and second home owners. Although a Florida judge dismissed the case, seasonal homeowners were awarded a 10 percent assessment cap in a 2008 voter-approved constitutional amendment.

Horizontal inequities such as those documented here are not limited to residential properties. Disparities are also prevalent within the commercial property class in California. In Los Angeles the owners of the then-new Wells Fargo Center paid \$1.77 per square foot in property taxes in 2003, and owners of the SunAmerica Center paid \$5.00 per square foot (Morain 2003). In contrast, businesses that were well established before the passage of Proposition 13 in 1978 paid far less. For example, the owners of Disneyland paid an average of five cents per square foot on its original property in 2003, and the owners of Capitol Records paid ten cents per square foot on its headquarters near the Wells Fargo Center.

Disparities of this magnitude are not uncommon, according to O'Sullivan, Sexton, and Sheffrin (1995a). They computed a median 1991 disparity ratio of 5.66 for commercial and industrial properties that had not changed hands since 1975, meaning that half the sample had disparity ratios greater than 5.66 and half had ratios less than the median. This median ratio declined

What Happens When Housing Prices Fall?

When Proposition 13 passed in June 1978, few California voters thought about how it might operate in a market downturn. Nevertheless, in November 1978 they passed Proposition 8, a constitutional amendment that does address declines in value. A property whose market value falls below its adjusted acquisition value (i.e., adjusted annually at the lower of the increase in the Consumer Price Index or 2 percent) must be assessed at market value. In subsequent years, the property must be reviewed and reassessed at market value until market value again exceeds adjusted acquisition value. When that happens, the adjusted acquisition value is reinstated as the assessed value, even if this results in an increase of more than 2 percent above the prior year's assessment.

Most property owners feel that decreases in the market value of their property should be reflected in lower tax bills. In reality, this will usually be the case only for properties that were recently sold, because their adjusted acquisition value may still be close to market value. For long-time owners, adjusted acquisition value is generally far below market value. Even declining market value will rarely fall below adjusted acquisition value, so taxable value will not decrease. In fact, the assessed value of the property may continue to increase if the Consumer Price Index rises and the adjusted acquisition value is not above market value.

Sharply declining property values from 1991 through 1995 diminished the gap between market value and assessed value in Los Angeles and San Mateo counties, thereby reducing some of the inequities in the property tax system introduced by Proposition 13 (Sheffrin and Sexton 1998). The recession also imposed a tremendous workload on county assessors throughout the recession and recovery. Statewide, the number of assessment appeals increased 300 percent in 1992–1993 and an additional 110 percent in 1993–1994.



to 3.23 in 1996 due to the recession, but had increased to 4.0 by 2002 (Sheffrin and Sexton 1998; Sexton and Sheffrin 2003).

EFFICIENCY (MOBILITY) EFFECTS

Acquisition value assessment discourages mobility (sometimes called a lock-in effect) because taxes can rise dramatically upon a change in ownership, even if the market value of the owner's new property is the same or less than the old one. Growing families may choose not to move to larger houses, which limits the supply of affordable starter homes—an effect seen in California—and older adults may not move to smaller homes when their children leave the household. Homeowners may not move if their job location changes, even if they face a longer commuting time. These kinds of individual choices result in inefficient resource allocation and decreased economic welfare.

O'Sullivan, Sexton, and Sheffrin (1995b) used a mathematical simulation model to estimate optimal housing moves and the loss of welfare (economic well-being) resulting from an acquisition value system. This welfare loss is sometimes referred to as an excess burden or deadweight loss, because it represents a burden on taxpayers over and above the amount of money transferred to the government in taxes. They found that an acquisition value tax produced relatively large excess burdens. For example, a revenue-neutral switch from a conventional property tax to an acquisition value system, assuming a 3 percent tax rate and property value appreciation of 6 percent, increases the median length of residency in a dwelling by about 18 percent and results in an excess burden of about 4.5 percent of total tax revenue.

In another study of the mobility effects of an acquisition value tax, Wasi and White (2005) found that from 1970 to 2000 the

average tenure length of California homeowners increased by 0.66 years, or 6 percent, compared with owners in Florida and Texas. This increase was found to be greater where housing values were higher, where they increased more rapidly, or both, so the mobility effect of Proposition 13 was greatest in the coastal areas of California.

California allows homeowners age 55 and older in some situations to take their assessed value with them to their new homes, thereby eliminating the moving penalty. Ferreira (2004) found that in 1990, 55-year-olds in California were 25 percent more likely to move than 54-year-olds. He also reported that homeownership rates in California, which are barely half the national average for young families, actually rise to the national level as homeowner age increases, a phenomenon not found in other states or in pre-Proposition 13 California.

In contrast to the above studies, Sjoquist and Pandey (2001) found that the assessed value freeze in Muscogee County, Georgia, had no significant effect on mobility, and hence no impact on housing turnover or community stability (see box 2, page 17). Stansel, Jackson, and Finch (2007) found no evidence of a lock-in effect in Florida based on a sample of 20 counties in 2002 and 2006. In fact, they found that average tenure declined slightly from 11.2 years in 2002 to 10.8 years in 2006, with lower tenure and larger declines in tenure in coastal counties.

The mobility penalty also affects business decisions. Like households, businesses will be less likely to move, even if their markets shift or their current quarters are no longer appropriate, if a change in location increases their property taxes. Moreover, existing businesses that have occupied their structures for a long period will have a tax advantage over new entrants, potentially reducing economic growth.



CHAPTER 5 Alternative Relief Measures

It is clear that some taxpayers benefit from assessment limits, but many others may receive no protection, and often they are among those most in need of property tax relief. What alternatives exist to assist needy homeowners facing rising property tax bills?

Rather than impose assessment caps and tax rate limits, some states restrict the growth in property tax revenues through levy limits or the growth in individual property tax bills through tax caps. However, these approaches are expensive because, like assessment limits, they tend to reduce taxes without regard to need. Moreover, limitations on total revenue may not be an appropriate response to rapidly rising individual tax bills if local spending is not the problem. Targeted options for residential tax relief include homestead ex-

emptions, classified tax rates, circuit breakers, and tax deferral programs. Finally, truth in taxation programs are designed to increase transparency and accountability by reporting to taxpayers on changes in the tax base, tax rate, and tax collections.

LEVY LIMITS

Levy limits specify the maximum amount of revenue that can be raised from the property tax in a jurisdiction. Prior to 1970 only five states imposed levy limits (Mikhailov 1998), but many such provisions have been adopted or strengthened in recent years, and today they exist in some form in 29 states (Anderson 2006). Levy limits typically take the form of a maximum allowable annual percentage increase in the property tax levy



Neighbors on the same street may face different circumstances that require different property tax relief measures.

(the total amount collected by a jurisdiction). These limits may apply to all government entities using the property tax, or to individual taxing jurisdictions such as school districts. Some states permit revenues to grow only by the rate of inflation, and many allow an exception for taxes on new construction.

These limits do not target relief to needy taxpayers; rather, by reducing collections, they can lower taxes on all types of property. If the loss in revenue is not compensated by state aid or other taxes and charges, the resulting reduction in local services can impose new burdens on the residents most dependent on those services. Even if state aid increases or the state assumes new expenditure responsibilities, local governments face a diminished ability to respond to the tax and service preferences of their voters.

A jurisdictionwide levy limit has the same impact as a combined jurisdictionwide assessment limit and tax rate cap. For example, if total assessed value is limited to 5 percent annual growth and the tax rate cannot increase, property tax revenues cannot increase by more than 5 percent per year.

Homestead exemptions may help those in owner-occupied principal residences.

Some states restrict tax increases that result from a general reassessment. These are often termed constant yield limits or roll-back limits. Again, tax base growth from new construction is generally excluded from the limit in these cases.

Because levy limits apply to jurisdictionwide tax collections, they do not protect individual homeowners from higher tax bills, nor do they prevent the redistribution of the tax burden across and within property classes. If appreciation in property values is not uniform, the tax burden will shift toward those properties appreciating the most rapidly. In an effort to provide individual homeowner relief, 10 of the 29 states with levy limits also have some form of assessment limit.

A limit on individual tax payments would ensure that tax bills did not rise by more than the specified percentage. Nevada recently instituted such a cap at 3 percent for homestead properties.

However, maintaining the existing distribution of the tax burden may violate principles of equity. If relative tax bills are unchanged while some properties rise in value and others fall, taxpayers face effective tax rates that depend on the rate of appreciation of their properties. This replicates a situation common in earlier decades when many assessors failed to update valuations even when required to do so by law. Over time, this lack of revaluation placed the highest tax burden on residents of poorer and declining neighborhoods, and the lightest burden on the more affluent residents of areas that had risen most in value.

HOMESTEAD EXEMPTIONS AND CREDITS

Homestead exemptions reduce property taxes by lowering the assessed value of owner-occupied principal residences. They are one of the oldest and most common forms of



property tax relief, dating back to the 1930s. Forty states and the District of Columbia offered homestead exemptions in 2005 (Baer 2005). Exemptions may be a set dollar amount or a percentage of assessed value, and they vary considerably among states in their provisions and eligibility requirements. Homestead credits offset specified amounts or percentages of taxes. For example, a \$20,000 exemption would result in a \$200 tax savings at a tax rate of 1 percent, the equivalent of a \$200 credit.

The relative tax reduction depends on the dollar amount of the exemption and the assessment ratio used to determine the taxable value. The household exemption for Louisiana is \$7,500, for example. Since the state uses an assessment ratio of 10 percent to reach taxable value, a \$200,000 home would have a \$20,000 assessed value before the exemption, and the \$7,500 exemption would reduce that by 37.5 percent, to \$12,500. In contrast, the \$7,000 exemption in California reduces the taxable value on a \$200,000 home by only 3.5 percent, to \$193,000, because its assessment ratio is 100 percent. The actual value of the exemption also depends on the statutory tax rate. California's \$7,000 exemption translates into a \$70 tax savings at its 1 percent tax rate.

Exemptions and credits for specified dollar amounts will result in a greater percentage tax reduction for owners of low-value homes, while exemptions and credits for a percentage of value will provide a greater dollar savings to owners of high-value homes. As the assessed value of the property rises, a percentage exemption will reduce taxes by an increasing dollar amount and the effective tax rate will remain constant. By contrast, a fixed dollar exemption will result in a constant dollar amount of savings, a declining percentage of savings, and an increasing effective tax rate.



CLASSIFIED TAX RATES

Homestead exemptions and credits lower the effective tax rate on owner-occupied residences, but not on other types of property. This tax shift can also be achieved directly by a system of varying effective tax rates on different property classes. Many states tax business property more heavily than residences, and this policy can even serve as a strategic element of tax reform. In Massachusetts, local communities are allowed to institute classified tax rates only after the state Department of Revenue certifies that their assessments accurately reflect full market values.

Classified rates are preferable to assessment adjustments as a means of shifting the tax burden because they retain the transparency and accountability of a market value tax base. The major criticism of classification is also its principal political attraction: the lack of accountability inherent in increasing the tax burden on owners not well represented in the voting population. Heavy tax burdens on commercial and industrial property can introduce horizontal inequities and discourage businesses from locating or

Classified tax rates can shift the tax burden from residences to business and industrial properties.

expanding in the jurisdiction. A perception of unfair tax shifts of this type led the British government to nationalize the taxation of business property in 1988.

CIRCUIT BREAKERS

Another popular form of direct property tax relief is the circuit breaker tax credit, which targets aid to low-income and elderly residents whose taxes exceed a given percentage of income, just as a circuit breaker offers protection from an electrical overload. Circuit breaker programs in 34 states are funded at the state level (Bowman 2008). Thus, unlike most other tax relief measures considered in this report, they do not reduce local tax collections. Although homestead deductions or credits are limited to homeowners, circuit breakers can benefit renters as well. Their provisions vary from state to state, but in general relief is inversely proportional to income, with benefits declining as income rises.

The two major forms of circuit breakers are called “sliding scale” and “threshold” programs. A sliding scale circuit breaker rebates a percentage of the tax paid, with the percentage declining as income rises. For example, senior homeowners in Nevada with incomes below the poverty line receive a rebate of 100 percent of tax paid; this percentage falls as income rises until rebates are fully phased out at an income level of \$27,863.

Threshold circuit breaker programs refund taxes that exceed a certain percentage of household income, again subject to limits on eligibility. In Rhode Island, households with incomes of \$30,000 or less receive rebates equal to the amount by which property taxes exceed a given percentage of their income. Taxpayers with incomes less than \$6,000 receive a refund on taxes that exceed 3 percent of their income. Those with higher incomes receive rebates for taxes above 4 percent if their income is between \$6,001

and \$9,000; 5 percent if their income is between \$9,001 and \$15,000; and 6 percent if their income is between \$15,001 and \$30,000.

Circuit breakers for renters operate similarly, based on state assumptions about how much property tax is included in rent. These property tax rent equivalents may reflect the supply and demand characteristics of rental markets as well as political negotiation.

Most state circuit breaker programs apply only to senior citizens, set a maximum income or wealth limitation, and place a ceiling on maximum benefits. Income eligibility requirements and benefit caps vary, but as the examples above demonstrate, most current programs set eligibility limits too low to be of assistance to many households. Even with more generous income ceilings, many middle-income taxpayers who feel pressure from fast-growing property taxes would be ineligible for relief because their taxes would not exceed the specified percentage of income.

Maximum benefits are generally not related to property tax liability, but often vary according to income. In 2007, benefit caps ranged from a low of \$75 in New York to \$2,000 in Maine and New Jersey (Bowman 2008). Legislative changes to all such provisions would be required for circuit breakers to extend widespread and general taxpayer relief.

Circuit breakers can be an efficient means to target property tax relief to the most needy, and when funded by state governments they do not reduce local budgets or local autonomy. Of course, obtaining state funding can be a political challenge, and this is a major reason why current benefits are so low. State-funded programs can also lead to overspending by local governments, because some taxpayers may vote for additional public services knowing that higher property taxes will be entirely offset by circuit breaker benefits.

Participation rates among taxpayers eligible for circuit breaker programs are often very low; in some states participation is as low as one-third to one-half of those eligible (Lyons, Farkas, and Johnson 2007). It is therefore important that circuit breakers be accompanied by educational efforts to publicize their availability and to explain their application procedures.

TAX DEFERRAL

Tax deferral programs offer another means of targeting property tax relief to needy households. They allow homeowners to delay the payment of taxes until the home is sold or the owner's estate is settled. The unpaid tax, together with any interest charges, is secured by a lien on the property. Deferral programs are primarily targeted to the elderly and disabled, often with income or residency requirements. Twenty-five states and the District of Columbia had some type of tax deferral program in place in 2005 (Baer 2005).

Washington State enacted a program in 2007 that offers homeowners with incomes of \$57,000 or less the option to defer half of their property taxes each year, up to a maximum of 40 percent of the equity in their home. Senior citizens with incomes of \$40,000 or less can defer all property taxes up to a maximum of 80 percent of their home equity. Any deferred taxes must be repaid with interest when the property is sold.

In the past, relatively few homeowners chose to defer their taxes, but that trend may be changing. Before the recent popularity of home equity loans, encumbering a residence was often viewed as imprudent. Anti-tax activists would prefer to lobby for tax reduction or elimination rather than to improve payment options for an existing tax. States have not generally publicized their deferral programs, so many taxpayers are unaware of them. However, interest in

reverse mortgages, by which home equity is liquidated into a series of cash payments, has grown rapidly in recent years, particularly among senior citizens. More than 132,000 elderly homeowners took out reverse mortgages in 2007, a greater than 270 percent increase in two years (Duhigg 2008).

Expanded tax deferral programs might find ready applicants in the future. Like phased-in revaluations, they could offer short-term assistance to all homeowners, not just seniors who are facing large one-year increases in tax payments. Moreover, these programs could improve public debate on tax reform by helping to ensure that citizens, especially the elderly, will not be dispossessed

Older residents in some states can take advantage of circuit breaker and tax deferral programs.



for unpaid property taxes. If this threat were eliminated, then a more complex weighing of public needs and appropriate tax levels would be possible.

TRUTH IN TAXATION

Truth in taxation programs increase public accountability when housing price increases cause the tax base to rise. They generally require a public notice, and sometimes an election, for tax revenues to exceed the prior year's collections, even without a rate increase. For example, the Texas truth in taxation law for school districts requires that property owners be notified of changes in their appraised value, and of the estimated taxes that could result from the new value. The school district must then publish its budget, its proposed tax rate, and the rollback rate that would collect the same amount of revenue as in the prior year. A public hearing and an election are required to raise

the tax rate above its rollback level (Texas Comptroller of Public Accounts 2007).

Virginia, Tennessee, Utah, and Maryland utilize truth in taxation programs (called a constant yield tax rate in Maryland) to promote public scrutiny of tax increases that follow rising assessed values. In Virginia, this is the only statewide program used to limit local property taxes. Utah's full disclosure law mandates that each local taxing jurisdiction determine a constant yield tax rate that, when applied to the current year tax base, would raise the same revenue as was collected in the prior year. Higher rates require a public hearing and notice, followed by a vote by the local government. Cornia and Walters (2006) studied the Utah situation and concluded that the full disclosure law had been instrumental in reducing or stabilizing property tax rates in a number of counties experiencing rising home prices.

Residents in Washington, DC, may be eligible for tax deferral programs.





CHAPTER 6 Conclusions and Recommendations

Assessment limits are often put forward as a means of combating two problems popularly associated with rapidly appreciating property values: increasing tax bills and the redistribution of tax burdens. In fact, 30 years of experience suggests that these limits are among the least effective, least equitable, and least efficient strategies available for providing property tax relief.

Assessment limits benefit those whose property values have increased rapidly, with the greatest tax reductions going to those whose property has risen fastest in value. At best, these limits restrict aid to those who have increased property wealth and provide no relief to those whose values are stagnant or declining. Yet even taxpayers whose assessed values have been reduced by these caps can face higher property taxes as rates rise to compensate for a diminished tax base. Rather than redressing shifts in tax burdens, these limits themselves cause substantial tax reallocations and unpredictable differences in effective property tax rates.

Better methods exist for addressing taxpayer discontent. The combination of truth in taxation measures and a circuit breaker program for low-income taxpayers could go a long way toward protecting those truly in need. Truth in taxation programs require local governments either to reduce tax rates when property values rise or to obtain approval for an undisguised tax increase. Circuit breaker credits are simple, direct, and targeted toward taxpayers who most need protection from rising tax bills.

Comparatively few states have truth in taxation programs or offer circuit breakers to the general population, and existing circuit breaker programs rarely offer adequate relief because income and benefit limits are set too low. A truly robust combination of truth in taxation and circuit breakers would constitute an innovative step toward assisting needy taxpayers without distorting the transparency of a value-based tax or introducing inefficiencies that impede economic growth.

Other instruments available to fashion effective property tax relief include homestead exemptions and credits, classified tax rates, deferred payment options, and the phase-in of new assessments. Homeowners facing large and unexpected increases in their tax liability have a legitimate expectation of government assistance. With these alternative tools legislators can respond to calls for property tax reform without the distortions, inequities, and unintended consequences of assessment limits.



GLOSSARY

Acquisition value: Fair market value at the time of the property's most recent sale.

Assessed value: The value assigned to a property for tax purposes. It may refer to market value or to another tax base. For example, in California it is the acquisition value plus an inflation adjustment of up to 2 percent per year.

Base year: Under an acquisition value system, the year of a property's most recent sale or change in ownership.

Disparity ratio: The ratio of market value to assessed value.

Effective tax rate: The ratio of the actual tax bill to market value.

Excess burden: The loss of welfare or satisfaction (economic well-being), over and above the amount of taxes paid, that results from changes in taxpayer behavior in response to the tax. This is also a measure of the loss to society from the distortion in the allocation of resources due to the tax.

Freeze: A valuation freeze does not permit valuations to rise, although taxes could still increase if the tax rate changes.

Homestead: An owner-occupied principal residence.

Horizontal equity: The principle of fairness that taxpayers in like circumstances should pay the same amount of property taxes.

Levy: Either the tax bill on an individual property, or the sum of the tax bills on all properties in a jurisdiction, in which case it is the same as property tax revenue.

Lock-in effect: A situation in which consumers face a disincentive to move or otherwise change ownership of their property.

Market value: The full and fair cash value of a property, or the price it would sell for in the open market.

Mobility effect: An impact on consumers' choices regarding moving. The lock-in effect is a negative mobility effect because it provides a disincentive to move.

Tax Price: If a local government increases spending by an amount equivalent to one dollar for each local taxpayer, the tax price faced by each taxpayer is the amount by which his or her tax bill would increase in order to finance the new spending.

Taxable value: The value to which the tax rate is applied in calculating the property tax bill, taking into account all deductions, fractional assessment ratios, and other adjustments.

Vertical equity: Fairness in the treatment of taxpayers in different circumstances.



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NOTES ON DATA SOURCES

NATIONAL HOUSING PRICE INDICES

(see figures 1 and 2)

Two major sources of national house price data in the United States are the indexes compiled by S&P/Case-Shiller (used in this report) and the Office of Federal Housing Enterprise Oversight (OFHEO). Standard & Poor's is a private firm engaged in financial analysis, and OFHEO is a federal regulatory agency within the Department of Housing and Urban Development.

The OFHEO data track conventional mortgages purchased or guaranteed by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). It has very broad geographic scope, but does not cover “jumbo,” unconventional, or some subprime loans. The S&P/Case-Shiller index uses data from the offices of county assessors and registries of deeds. It covers all types of loans, but draws data only from 100 major metropolitan areas. The OFHEO national index is published monthly, and the S&P/Case-Shiller national index is released quarterly.

EFFECTIVE PROPERTY TAX RATES

(see figure 5)

This figure calculates the effective property tax rate for business property as the estimated business property tax divided by the sum of (1) nonresidential property owned by nonfarm, nonfinancial corporate business at market value; (2) nonresidential property owned by nonfarm, noncorporate businesses at market value; (3) residential property owned by nonfinancial corporate business at market value; (4) equipment owned by nonfarm nonfinancial corporate business (replacement cost); and (5) equipment owned by noncorporate business (replacement cost). Asset data was obtained from the Federal Reserve Flow of Funds balance sheet data for relevant sources.

In this figure, the effective residential property tax rate equals the Ernst & Young estimated household property tax divided by the sum of the value of households and nonprofit organization real estate, excluding nonprofits, and household motor vehicles (net stock). Real property values were obtained from the Federal Reserve Flow of Funds balance sheet data for households and nonprofits; motor vehicle values were obtained from the Bureau of Economic Analysis detailed residential fixed-asset tables (Phillips, Cline, and Neubig 2008, 26).

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Lessons from Thirty Years of Experience

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