820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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THE PROBLEMS WITH PROPERTY TAX REVENUE CAPS

By Karen Lyons and Iris J. Lav

Several states (Connecticut, Florida, Minnesota, New Jersey, Rhode Island, and Texas) have recently considered imposing severe caps on property tax revenue.[1] These caps restrict the amount that property tax revenue can increase from year to year to a low fixed percentage, a formula based on the inflation rate, or some combination of the two.[2]

While such caps may hold down property taxes, they are likely to impair local governments' ability to provide education, public safety, and other services residents demand and need. They also are likely to make the local revenue system more regressive.

Property tax caps do nothing to change the main drivers behind higher property taxes. They cannot slow the increase in the cost of health care or fuel, for example, which reflects forces outside of the control of local officials. Nor do they change the demand for local public services, such as quality K-12 education, public safety, and good roads.

There are ways to mitigate the effects of property tax caps by replacing the lost revenue, but each of them has serious drawbacks:

KEY FINDINGS

- Property tax revenue caps do nothing to change the rising costs facing localities; they only make it harder for localities to provide the services residents demand and need.
- Increased state aid may help localities avoid cutting services in the short run, but such aid is often unreliable over time.
- Localities may pass overrides or increase other local sources of revenue, but such actions can increase funding inequities among localities and make the revenue system more regressive.
- When localities have not been able to replace lost property tax revenue, the quantity and quality of services such as schools, public safety, and infrastructure has declined.
- Homestead exemption and circuit breaker programs offer ways to lower property taxes without jeopardizing public services.

[1] In July 2006, the Rhode Island legislature passed a bill to lower the state's property tax revenue cap from 5.5 percent to 4 percent by fiscal year 2013. In April 2007, New Jersey passed a property tax revenue cap that limits revenue growth to 4 percent per year for five years.

[2] For example, Massachusetts' Proposition 2 ½ allows 2.5 percent growth per year, Colorado's Taxpayer Bill of Rights (TABOR) restricts growth to the inflation rate, and for certain localities in Illinois, property tax revenue can increase by the lesser of 5 percent or the inflation rate.

- Increased state aid to replace property tax revenue is sometimes promised at the time a cap is enacted. The evidence suggests, however, that state aid is not reliably sustained over time — particularly during economic downturns, when state aid to localities often declines.

- Most caps include provisions permitting citizens in a locality to vote to override the limit temporarily, or sometimes even permanently. Citizens unhappy with deteriorating services have frequently used this provision. The evidence suggests, however, that wealthier communities both attempt more overrides and are more successful in passing them. This can exacerbate disparities across the state in education and other important services, leaving lower-income communities even worse off relative to their higher-income counterparts.

- Localities may shift their revenue bases to other local sources, such as local sales taxes and fees, if permitted to do so under state law. The evidence suggests that localities under property tax caps often shift to these other revenue sources in order to maintain existing services. Such shifts, however, can place greater tax burdens on low-income residents than if the property tax were maintained.

When none of these strategies succeeds in completely alleviating the effects of the cap, serious reductions in the level and quality of public services are likely to follow. For example, K-12 spending per pupil in California fell dramatically under Proposition 13, dropping from more than \$600 above the national average in 1978 (when Proposition 13 was passed) to more than \$600 *below* the national average in 2000.[3] School districts in the state have been forced to cut programs such as music, physical education, and art; reduce class offerings; and cut positions, such as librarians and counselors.[4]

Similarly, some Massachusetts towns have had to lay off school and municipal employees (including fire and police), freeze wages, close the town library and senior center, and stop funding infrastructure projects in order to comply with that state's severe property tax cap.[5] And in Illinois, school districts affected by the state's cap have eliminated positions, reduced the number of teaching assistants, imposed salary freezes, and cut certain classes.[6]

Academic studies have found that in most cases, property tax limits have led not to a shrinkage in the public sector but instead to a shift to other revenue sources, such as state aid and fees. In places where the caps have had an effect, however, the outcome has been negative. For example, evidence suggests that caps disproportionately affect lower-income communities: "the implications are that [tax and expenditure limits] are most constraining on the ability of governments serving economically less prosperous and at-risk populations to meet public service needs," according to a

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[3] Jennifer Sloan McCombs and Stephen J. Carroll, "Who Is Accountable for Education If Everybody Fails?" RAND, 2005, http://www.rand.org/publications/randreview/issues/spring2005/ulttest.html.

[4] Tom Bell, "Fort Bragg schools feel sting of Proposition 13," *Portland Press Herald*, May 16, 2004.

[5] Massachusetts Municipal Finance Task Force, "Local Communities At Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," September 2005, http://www.mapc.org/Municipal_Finance_Task_Force/Local%20Communities%20At%20Risk%20Report.pdf.

[6] Linda Dawson, "Feeling the impact of tax caps," *Illinois School Board Journal*, January-February 2001.

study by Dr. Daniel Mullins, an expert on state and local fiscal issues.[7] Some studies have found strong evidence that property tax caps lead to lower student test scores; they may also lead to higher dropout rates and a reduction in teacher preparedness.[8]

Homestead Exemptions, Circuit Breakers Are Preferable to Caps

If policymakers believe that some residents are paying more property tax than they can afford, there are better options for lowering property tax bills. Homestead exemptions and circuit breakers give taxpayers significant targeted relief without undermining a community's quality of life.

- *Homestead exemptions* exclude a specified amount of the value of a property from taxation. The amount generally represents a higher proportion of the assessment of lower-valued property than higher-valued property. Thus, while a homestead exemption provides tax relief to all homeowners, it provides the greatest relief to residents living in modest homes.

- *Circuit breakers* limit the percentage of a household's income that the household should be expected to pay in property taxes. Households whose property tax payments exceed that limit get a rebate from the state for all or part of the difference. Circuit breakers are particularly effective in helping senior citizens living in homes purchased many years before, people living in gentrifying neighborhoods, and people who have lost income due to unemployment or illness.

Unlike a property tax revenue cap, homestead exemptions and circuit breakers target tax relief on residents who most need it. Moreover, since these programs are paid for by the state, local services are not threatened.

Rigid Property Tax Caps Do Not Reflect the Cost of Public Services

Twenty-four states have some form of limit on the annual increase in property tax revenue collected by a county, municipality, or school district.[9] Many of these limits are less stringent than the caps recently being considered across the country.

Five states (Arizona, Idaho, Kentucky, Massachusetts, and West Virginia) have a fixed percentage growth cap of 5 percent or less. Three states (Colorado, Michigan, and Montana) limit growth to the overall inflation rate, which over the past decade has averaged about 2.6 percent per year. And six states (California, Illinois, Missouri, New Mexico, South Dakota, and Washington) limit growth to

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[7] Daniel R. Mullins, "Tax and Expenditure Limitations and the Fiscal Response of Local Government: Asymmetric Intra-Local Fiscal Effects," *Public Budgeting & Finance*, 24:4 (2004), pp. 111-147.

[8] Thomas Downes and David Figlio, "Do Tax and Expenditure Limits Provide a Free Lunch? Evidence on the Link Between Limits and Public Service Quality," *National Tax Journal*, Vol. 52 No. 1 (March 1999), pp. 113-128.

[9] This list does not include New Jersey, whose cap is not yet in effect, or states that have caps only on school districts. It does include California because the state's combination of an assessment limit (assessed property values cannot increase by more than the lesser of 2 percent or the inflation rate) and a rate limit (rates cannot exceed 1 percent of assessed value) has an effect similar to that of a property tax revenue cap.

the lesser of a fixed percentage or the inflation rate. (See Appendix.) In most states, the limit excludes new construction and can be overridden with voter approval.[10]

Proponents of property tax caps claim that local governments are not spending taxpayers' money efficiently and that limiting the property tax revenue they can collect will force officials to cut waste, while causing little or no harm to local public services. This argument, however, overlooks two essential points: 1) the costs associated with providing local services, such as health insurance and pensions for local employees, are rising rapidly and are expected to continue to do so for the foreseeable future; and 2) the majority of these costs are outside localities' control.

Thus, limiting the growth in property tax collections to the inflation rate or a similarly low percentage greatly hinders localities' ability to maintain the current level and quality of public services, such as K-12 education, public safety, and roads. Such limits also preclude improvements in public services.

Inflation, which is generally defined as the Consumer Price Index (CPI), measures the change in the total cost of a "market basket" of goods and services purchased by a typical urban consumer.[11] A typical urban consumer spends a majority of his or her income on housing, transportation, and food and beverages, so these are the primary drivers of the CPI. By contrast, local governments spend their revenue primarily on education, health care, and public safety. Since the market baskets for urban consumers and local governments are entirely different, the inflation rate does not adequately measure the change in costs of providing public services.

A fixed percentage can be equally problematic. It incorrectly assumes that some single percentage can effectively capture the "proper" growth in local government costs each year in perpetuity.

Costs Outside Localities' Control Increasing Faster than Allowed Rates

In order to provide residents with the services they demand, localities must employ teachers, librarians, and police officers; buy fuel for school buses, fire trucks, and garbage trucks; and maintain roads, parks, and jails. Most of the costs incurred for undertaking these actions have been increasing rapidly in recent years, and this cost growth is largely outside localities' control.

For instance, a recent study found that between 2000 and 2006, Florida counties saw their pension costs rise an average of 11 percent per year, their employee health insurance costs rise an average of 17 percent per year, and their fuel and utility costs rise an average of 25 percent per year.[12] (See

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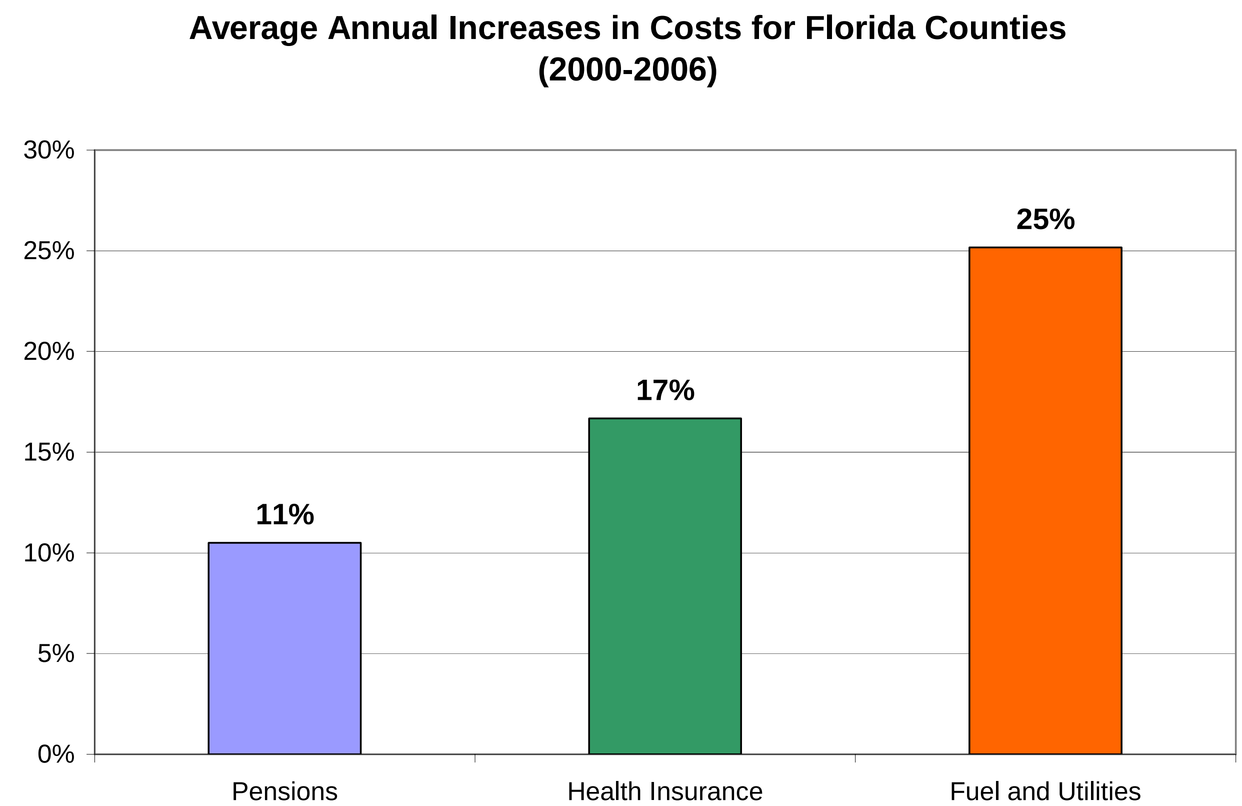
[10] The fact that property tax revenue caps generally exempt new construction, property additions, and improvements does not significantly reduce their severity. This is because new construction brings with it the need for more public services, in particular schools and roads. Also, the revenue received from this new construction does not help to fund the annual increase in the cost of providing the existing level of services.

[11] More specifically, inflation is defined as the Consumer Price Index- All Urban Consumers (CPI-U), which is calculated by the U.S. Bureau of Labor Statistics.

[12] Dr. Hank Fishkind, "Analysis of County Spending Patterns, 1999-2006: Where Did The Money Go?" Florida Association of Counties, March 7, 2007, http://www.fl-counties.com/proptax/_doc/fishkind_study.pdf.

FIGURE 1



Source: Dr. Hank Fishkind, "Analysis of County Spending Patterns, 1999-2006: Where Did The Money Go?" March 7, 2007, http://www.fl-counties.com/proptax/_doc/fishkind_study.pdf

Figure 1.) These increases are well above the increases allowed under strict property tax revenue caps. (For example, inflation averaged 2.8 percent per year over this same period.) If such increases were to be accommodated under a cap, other expenditures would have to be cut substantially. While Florida's high population growth contributes to its rising costs, local governments across the country are facing costs that are rising more rapidly than the typical property tax growth limit.

Health Insurance Costs

Health insurance for local government employees is one area that has experienced large cost increases. In a recent survey by the National League of Cities, workers' health benefits was named most often by city finance officers as the factor having the largest negative impact on their ability to meet city needs. The study also found that health care costs are increasing faster than city revenues.[13]

[13] Michael A. Pagano and Christopher Hoene, "City Fiscal Conditions in 2005," National League of Cities, Research Brief on America's Cities, Issue 2006-1, January 2006.

This is not surprising: premiums for employer-sponsored health insurance rose by 11 percent in 2004, 9 percent in 2005, and 8 percent in 2006.[14] And health insurance takes up a significant portion of local budgets because local services tend to be highly labor intensive. In fact, nearly 50 percent of all local expenditures for current operations are for salaries alone.

In Massachusetts, municipal spending on health insurance increased by an average of 16 percent per year between 2001 and 2006. These increased health costs consumed an estimated *80 percent* of the property tax revenue increases allowed during this time period under the state's strict property tax cap.[15]

Localities in other states have had similar experiences. For example:

- Local governments in New York saw their expenditures on employee health insurance increase an average of 13 percent per year from 2000 to 2004.[16]

- Health insurance costs for the city of St. Croix, Wisconsin, increased 21 percent from 2006 to 2007.[17]

- In Washoe County, Nevada, health insurance costs are expected to rise 13.5 percent for fiscal year 2008.[18]

These increases can have serious consequences. In Clackamas County, Oregon, health insurance costs and employee pensions for the sheriff's office have ballooned, outpacing the department's budget. As a result, staff have been fired, the department now takes longer to respond to violent crimes, and often it cannot respond at all to nonviolent crimes.[19] A property tax revenue cap would put additional pressure on a locality to make such budget cuts.

It has been argued that a property tax cap can spur a state to restructure health care and other services to make them more efficient. For example, Massachusetts is considering allowing localities to opt in to the insurance plan for state workers, which would enable localities (and their employees) to benefit from the state's greater bargaining power with insurers. In fact, however, such reforms are being adopted or considered by states *with and without caps.* Across the country, local officials are concerned about rising costs, and they often look to the states to help them with these types of solutions.

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[14] The Henry J. Kaiser Family Foundation, "Employee Health Benefits: 2006 Annual Survey," September 2006, http://www.kff.org/insurance/7315/index.cfm.

[15] Massachusetts Municipal Finance Task Force, "Local Communities At Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," September 2005, http://www.mapc.org/Municipal_Finance_Task_Force/Local%20Communities%20At%20Risk%20Report.pdf

[16] Office of the New York State Comptroller, "2006 Annual Report on Local Governments," November 2006.

[17] Presentation, "St. Croix County Board 2007 Budget Approved October 31, 2006," www.co.saint-croix.wi.us/PDFs/2007BudgetPresentation.pdf.

[18] Washoe County website: http://www.washoecounty.us/finance/budget_facts.html?PHPSESSID=5ae2a30233234932e1bca6248ec7ce54.

[19] Aimee Green, "Will a deputy respond when you call 9-1-1?" *The Oregonian*, September 28, 2006.

Pensions

There has been increased scrutiny recently over whether the defined benefit pension plans most governments utilize are actuarially sound — that is, whether governments are setting aside sufficient funds to deliver on the promised pension benefits. Most public plans are underfunded, and many localities are having to make rapidly growing annual payments to adequately fund future pensions. For instance:

- The fiscal year 2007 budget for Orange County, California, included a 40 percent rise in pension contributions on behalf of county employees.[20]

- Pension costs in Buffalo, New York, have increased five-fold over the last five years. In New York City, they have quadrupled over that period and will soon consume 10 percent of the city's budget.[21]

- In the city of Bristol, Virginia, public employee pension contributions increased by 25 percent in 2005 alone.[22]

Demographics are part of the problem. Retirees are living longer than previously assumed, which means that local governments must increase their contributions to the pension system.

Localities' past actions are another factor. A number of localities improved pension benefits in the 1990s, when fiscal conditions were good; this necessitated increased contributions (including "make-up" contributions to offset the now-inadequate past contributions). Also, some localities — and states — have skipped payments destined for pension funds, using them instead to meet other needs. During economic downturns or when other fiscal pressures are strong, it is common for localities to omit, reduce, or postpone payments into pension funds. Still other localities have borrowed from pension funds. When a locality skips payments or borrows pension funds, it must repay those funds in some future year(s), along with all of the foregone investment income.

Examples of underfunded pension funds include:

- In Kentucky, cities' pension costs jumped from $120 million in FY 2006 to $180 million in FY 2008 and are projected to reach $370 million by 2013. According to the Kentucky League of Cities, about 50 percent of Kentucky cities have used "rainy day" funds to pay for the increase, 40 percent have delayed filling open positions, and about 25 percent have either raised taxes or cut positions.[23] (Note that Kentucky has a strict property tax revenue cap.)

- Two of Montana's largest pension plans, which cover more than 90 percent of all local and state employees, have a combined $1.5 billion in unfunded liabilities.

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[20] Norberto Santana Jr., "Rise in pension cost tough to measure," *The Orange County Register,* June 15, 2006.

[21] Danny Hakim, "Cost of Pensions Adds to Factory Town's Troubles," *New York Times,* September 4, 2006.

[22] John Petersen, "Public Employee Pensions: Thinking the Unthinkable," *National League of Cities News,* November 14, 2005.

[23] Dan Hassert, "The public pension squeeze," *The Kentucky Post,* April 14, 2007.

- The North Dakota Teachers' Fund for Retirement has almost $500 million in unfunded liabilities.

- Minnesota's largest pension fund, the Public Employees Retirement Association, faced a $4 billion shortfall in 2005, more than double the level just three years earlier.[24]

These funding pressures generally are mitigated in periods when the stock market is rising, because higher investment returns can substitute for some of the contributions localities would otherwise make. Recent rises in the market have provided some relief. Conversely, when the market is down, required contributions can increase. A rigid property tax cap, however, does not allow for years in which contributions have to be greater. Either the contributions cannot be made, or some other areas of public services have to be cut to accommodate the higher pension payment.

Fuel Costs

Local governments face large increases in fuel costs for buses, garbage trucks, police cars, and fire engines. The price of gasoline has been rising rapidly across the United States, thanks in large part to rising crude oil prices. Gas prices have jumped as much as 30 percent annually in some recent years. (See Figure 2.)

School districts, especially those in rural or highly populated areas, have been hit particularly hard. School buses are not fuel efficient: gas buses get only five to six miles to the gallon, while diesel buses get about 10 to 11 miles to the gallon. While there is no systematic data on the impact of these increases, school districts from Whitfield County, Georgia to Fresno, California, have reported fuel cost increases ranging from 30 to 60 percent.[25]

Some school districts have responded by canceling field trips, off-site sports games, and off-site after-school activities. School districts in two states have gone to even greater lengths. In Rhea County, Tennessee, rising fuel costs caused school officials to close schools for two days.[26] And Salmon, Idaho permanently reduced the school week from five to four days because of fuel costs.[27] (Note that Idaho has a strict cap on property tax revenue.)

The Challenge for Local Governments

Local governments cannot avoid the rising costs of health insurance, pensions, and fuel detailed above; instead, they have to find ways to accommodate them in their budget. This will be much more difficult for localities operating under a property tax revenue cap.

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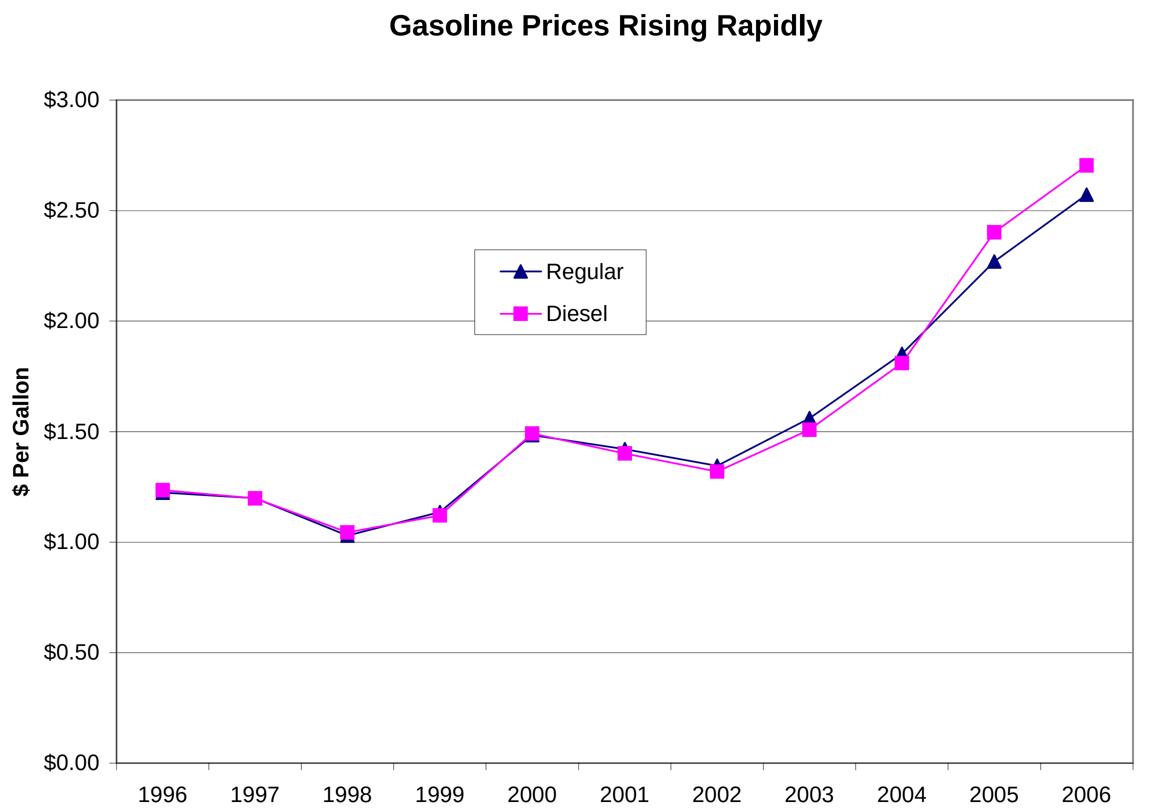
[24] Ronald A. Wirtz, "Pension Deficit Disorder," Federal Reserve Bank of Minneapolis, May 2006.

[25] Ben Benton, "Fuel tab hits schools," *Chattanooga Times Free Press*, August 8, 2006; Kerri Ginis, "Valley governments feel strain at the pump," *The Fresno Bee*, May 5, 2006.

[26] Bill Poovey, "Fuel Costs Prompt School Closings in Tenn.," The Associate Press, May 1, 2006.

[27] Laura Zuckerman, "Students are getting a day off as schools battle soaring fuel costs," *The Star-Ledger*, May 19, 2006.

FIGURE 2



Source: U.S. Department of Energy, Energy Information Administration

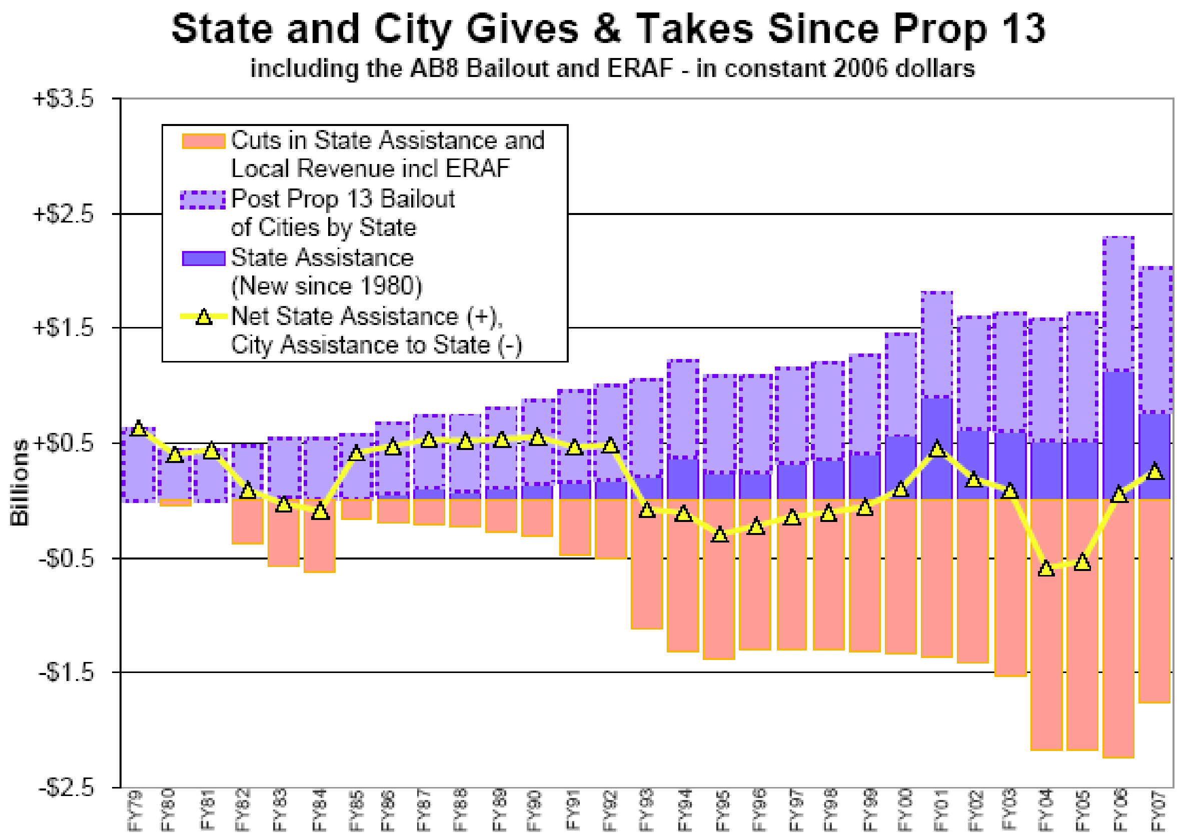
Given this problem, states and localities operating under caps have used a variety of methods to mitigate their effects. These include infusions of state aid, the use of override provisions, and increases in other available revenue sources. As explained below, however, each of these methods has serious drawbacks.

Additional State Aid May Be Promised, But Is Unlikely to Be Sustained

When a state enacts a property tax cap, it may promise localities additional aid. This promise may be fulfilled at first but is unlikely to be sustained over time, especially during economic downturns. State aid to localities is highly dependent on the state's revenue situation: when revenue growth is strong, the state may provide localities with additional aid, but when revenues slow or stagnate, it may cut aid.

Since property tax caps are often implemented during times of economic and fiscal growth, when property values are rising, state aid to localities is often robust in the first few years of the cap. In enacting Proposition 13, for example, California provided its cities with roughly $220 million in

FIGURE 3



Note: ERAF stands for Educational Revenue Augmentation Fund and refers to property tax allocation changes instituted in the early 1990s. Source: California Local Government Finance Almanac, www.californiacityfinance.com

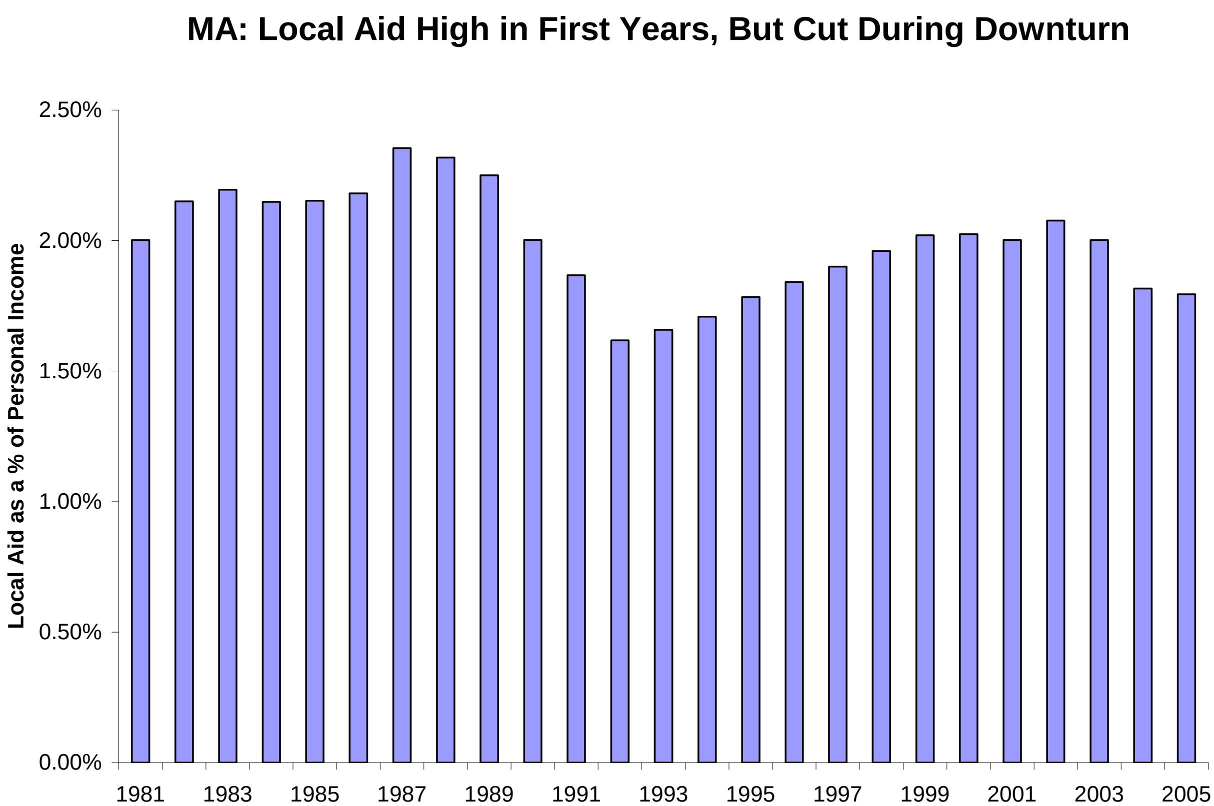
block grants, its counties with $430 million, and its special districts with $190 million.[28] Similarly, in Massachusetts, state aid to localities grew by more than 10 percent annually in the first three years following the enactment of Proposition 2 ½. [29]

However, once state revenues weaken due to a tax cut or an economic downturn, states often reduce local aid. During a downturn, cutting local aid is a particularly attractive option for states because it allows them to reduce their budget without hurting the public services they provide. Such cuts in aid are likely to occur even when legislators know that local governments are constrained in their capacity to raise revenues.

[28] The state also assumed the responsibility for certain services. See Jeffrey Chapman, "The Continuing Redistribution of Fiscal Stress: The Long Run Consequences of Proposition 13," Lincoln Institute of Land Policy, 1998.

[29] Massachusetts Municipal Finance Task Force, "Local Communities At Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," September 2005, http://www.mapc.org/Municipal_Finance_Task_Force/Local%20Communities%20At%20Risk%20Report.pdf.

FIGURE 4



Source: Massachusetts Budget and Policy Center, April 2006

California cut local aid during the nationwide recessions of the early 1980s and the early 2000s, as well as during the state's recession from 1991 to 1994 (which outlasted the national downturn). It also cut local aid when there were large tax cuts during the mid- to late 1990s.[30] (See Figure 3.) Similarly, Massachusetts cut local aid during the recessions of the early 1990s and early 2000s. (See Figure 4.) In Minnesota, state aid to cities also fell precipitously between 2002 and 2004.[31]

These examples show that even though state aid may initially provide localities with a sizeable amount of revenue, localities cannot depend on this added revenue over the longer term.

30 For example, a $1.3 billion tax cut resulted from the expiration of the upper-income tax brackets at the end of 1995. See also See Nicholas Johnson and Brian Filipowich, "Tax Cuts and Continued Consequences: States That Cut Taxes the Most During the 1990s Still Lag Behind," Center on Budget and Policy Priorities, December 19, 2006.

31 Nathan Anderson, "Responses of Local Governments in Minnesota to Changes in State Aid," prepared for the Urban Institute conference "State and Local Finances After the Storm: Is Smooth Sailing Ahead?" March 30, 2007.

Local Options Exist But Have Serious Problems

Given the unreliability of state aid, localities operating under a strict property tax cap will likely have to look for other ways to accommodate the rising cost of public services. In general, they have three options: pass overrides, increase their reliance on other local revenue sources (if they have the authority to do so), and/or make budget cuts. Each of these options has serious problems.

TABLE 1
COLORADO LOCAL GOVERNMENT OVERRIDES
(1993-2005)

	Municipalities	Counties
Number of localities in state	271	64
Number that have passed overrides of their TABOR limit	238 (88%)	60 (94%)
Number that have permanently rejected their TABOR limit	83 (31%)	44 (69%)

Source: CBPP analysis of survey data collected by the Colorado Municipal League and Colorado Counties Inc.

Overrides Can Create Inequities Among Localities

Most property tax cap proposals allow localities to override the cap with voters' approval. In states that have severe caps and allow local overrides, these overrides are utilized frequently. In Colorado, for instance, 88 percent of the state's municipalities and 94 percent of its counties have overridden the state's TABOR limits as they apply at the local level.[32] (See Table 1.)

This suggests that even when voters seem to favor caps in theory, such as by supporting a statewide initiative, they may reject the caps when confronted with the real-world implications of public service cuts in their own communities.

The potential for budget cuts in the absence of an override was arguably greater in Colorado than in other states with caps, since TABOR limits both property tax revenue *and* all local spending. It also limits state revenue growth, which meant the state could not increase aid to substitute for lost local revenues. In other states, the track record for overrides is more mixed. For instance, in Massachusetts, overrides have passed only 39 percent of the time.[33]

The Massachusetts example exposes an even more troubling problem: the override process can exacerbate inequities in public services among communities across the state. For example, higher-income communities in Massachusetts both attempted more overrides than lower-income communities and were more likely to approve them. (See Figure 5.) Also, smaller communities were more likely to approve overrides than larger communities (Boston has never approved an

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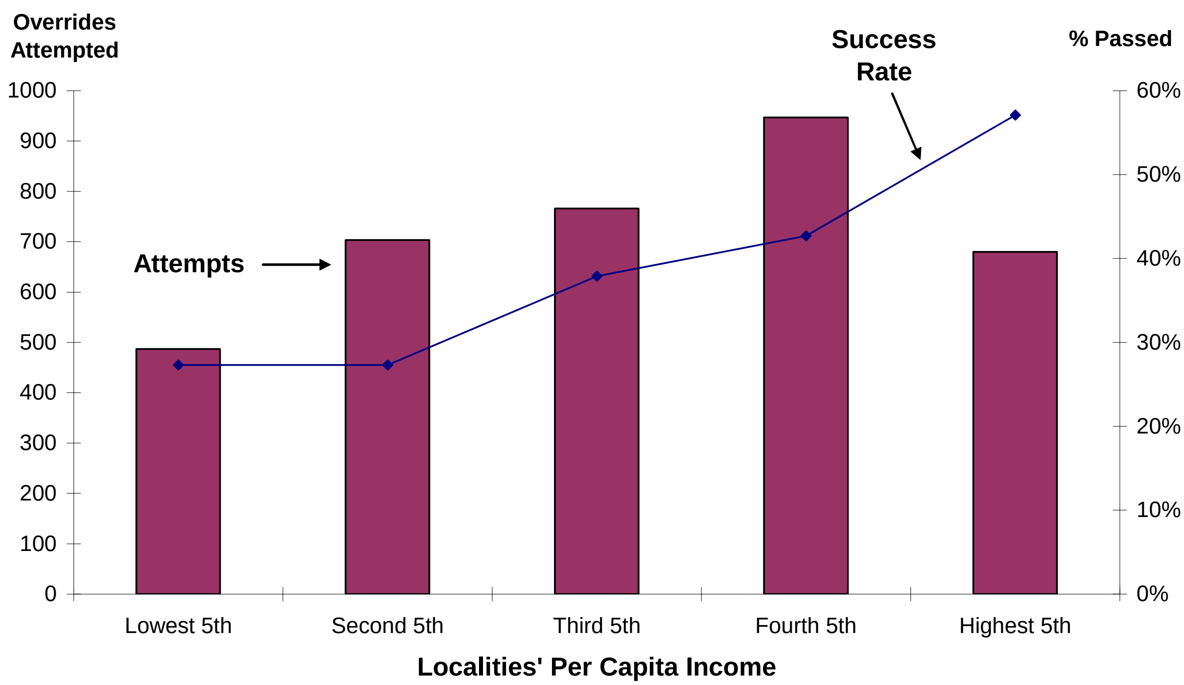
[32] At the local level, TABOR — the Taxpayer Bill of Rights — restricts yearly property tax revenue growth to inflation plus annual local growth; it restricts total local government spending growth to inflation plus a local growth factor.

[33] Massachusetts Municipal Finance Task Force, "Local Communities At Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," September 2005, http://www.mapc.org/Municipal_Finance_Task_Force/Local%20Communities%20At%20Risk%20Report.pdf.

FIGURE 5

MA: Higher Income Localities Attempted More Overrides, Had Greater Success Rate



Source: Massachusetts Municipal Finance Task Force, "Local Communities At Risk: Revisiting the Fiscal Partnership Between the. Commonwealth and Cities and Towns," September 2005, http://www.mapc.org/Municipal_Finance Task_Force /Local%20Communities%20At%20Risk%20Report.pdf.

override).[34] And communities with more school-age children were more likely to approve overrides than those with fewer children.[35] This suggests that some Massachusetts children are more likely than others to receive an adequately funded education, simply because of the community in which they are being raised.

Another problem with overrides is that they require a substantial public education campaign, since few voters pay close attention to their local budgets. Such campaigns are a lot of work. One organization that promotes such overrides in Massachusetts reports: "The vast majority of campaigns will require some funding for literature production, phones, stamps and office supplies. Additional costs could include short-term rental of office space and equipment, coffee and/or food for volunteers, Web site maintenance and advertising."[36] Repeated in dozens or hundreds of communities across a state, such campaigns could easily cost millions of dollars — and consume tens of thousands of hours of volunteer time.

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34 *Ibid.*

35 Laura Barrett, *Better Funding, Better Schools: A Roadmap to Overriding Proposition 2 ½*, Massachusetts Teachers Association, 2002.

36 *Ibid.*

In addition, these campaigns often need to be repeated year after year because override provisions are usually valid for only one year. This can create “campaign fatigue” among volunteers. It also means that override decisions may be made during off-year elections, which often have very low turnout — so important local public finance decisions may be made by a small minority of voters.

Shifting to Other Local Revenue Resources Can Have Negative Consequences

If state law permits, localities limited by a property tax cap may try to recoup some of their lost property tax revenue by shifting to other local revenue sources, namely fees and local option sales taxes.

In the area of fees, local governments have sought to offset property tax caps by raising fines, the cost of obtaining licenses and permits, admission to city swimming pools, or the charges for trash collection. Some localities — especially in California — have imposed developer fees, which are used to fund the infrastructure connected to new developments, such as schools, parks, sewage lines, lighting, and roads.

Developer fees are problematic, however, because they are usually passed on to homebuyers through higher home prices. For instance, in some California communities, home prices increased between 25 cents to over a dollar for every dollar of developer fees imposed.[37] Such increases can prevent lower- and middle-income families from buying a home; they also mean larger mortgages for families that can still afford to buy. Often, homebuyers do not know what kinds of fees were levied against the developer or how much of them the developer passed on.

Another problem with fees is that, unlike property tax payments, fees are not allowed as a federal tax deduction. If a state shifts from property taxes to fees, it effectively increases residents' federal tax burdens.

Local option taxes — generally sales taxes — are another revenue option for some localities. Seventeen states do not allow any type of local sales tax.[38] In the remaining states, only certain municipalities or counties are able to exercise this option, and there are often restrictions on the rate that may be levied.

The main drawback with sales taxes is that they fall most heavily on low-income households, which are more likely than more-affluent households to consume (rather than save) nearly all of their income. Lower-income households also are less likely to own a home than more-affluent ones.[39] Thus, raising sales taxes in order to hold down property taxes makes the tax system more regressive: low-income households will end up paying an even greater share of their income in taxes to support local services, while middle- and high-income households will see their tax burden reduced.

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[37] Jeffrey Chapman, “Proposition 13: Some Unintended Consequences,” Public Policy Institute of California, 1998.

[38] There is no local option sales tax in Connecticut, Delaware, Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, Montana, New Hampshire, New Jersey, Oregon, Rhode Island, Vermont, or West Virginia. Source: CCH Tax Research NetWork

[39] As noted below, renters do pay property taxes. The property taxes landlords pay are to some degree passed through in the rent they charge. The extent to which renters would benefit from a property tax cap is uncertain, however.

Other Kinds of Property Tax Caps

This paper focuses on caps on property tax revenue growth. There are two other main types of property tax caps: tax-rate limits and assessment limits.

Tax-rate limits come in several forms. Some limit the overall property tax payment to a certain percentage of the property's assessed value. (For instance, property tax rates in California are capped at 1 percent of the property's assessed value; in Oregon they are capped at 1.5 percent of assessed value.) Others freeze existing tax rates, as in Colorado. In general, tax-rate limits allow overrides with voter approval.

It is important to note that tax-rate limits may not actually reduce a household's property tax bills if assessments are rising in the area. However, if assessments are also capped, as in California, then the combination of the rate and assessment caps produces a result similar to the caps on total revenue growth discussed in this report.

Assessment limits typically limit the growth of an individual property owner's assessment to a specific percentage. For instance, both California and Washington cap a property owner's assessment increase to the lesser of the inflation rate or 2 percent. Assessment limits do not guarantee a reduction in property tax bills either, since the tax rate can still increase.

Assessment limits are often presented as helping the elderly and others on fixed incomes. In fact, however, they disproportionately benefit higher-income taxpayers living in desirable areas, where assessments often increase most rapidly. In addition, since the limits allow for homes or businesses to be assessed at their full value once sold, they make it more difficult for growing families to buy the larger houses they need. Lastly, they can cause inequities, as homeowners on the same block can face very different property tax bills depending on when they bought their homes.

Moreover, sales tax revenue is more volatile than property tax revenue. According to the National Conference of State Legislatures, sales tax collections tend to vary with national economic conditions. During economic downturns, people generally reduce their consumption (thereby reducing sales tax collections) *and* require more public services, so state revenues weaken even as state costs rise. The property tax, in contrast, is one of the most stable revenue sources.[40] If local governments were to shift from property tax revenue to the less consistent sales tax, budgeting would become much more difficult.

Another problem with sales taxes is that they can create disparities among localities, since some towns and cities will be better suited than others to levy the tax. For instance, urban areas and those with strong tourism bases will have an advantage over rural areas and those with little tourism. Local-option sales taxes can also lead to the "fiscalization of land use," as localities make land-use decisions in part on fiscal considerations. For example, localities will attempt to attract big-box retail stores, shopping centers, car dealerships, and hotels (because they would bring in new sales tax revenue) while discouraging new housing (because it would increase the need for schools and other services).

[40] Source: http://www.ncsl.org/programs/press/2004/pr040824.htm. See also David Brunori, *Local Tax Policy: A Federalist Perspective*, The Urban Institute Press, October 2003.

States Can Lower Property Tax Bills *Without* Hurting Public Services

Policymakers often look to property tax caps to protect certain residents from unaffordable or rapidly rising property tax bills. Many elderly residents and residents of rapidly developing or gentrifying areas do face these problems. So can people making moderate incomes, such as teachers or firefighters, and people who have temporarily lost income because of illness or unemployment. But a property tax cap — with all of its abundant problems — is not the only response. States can target property tax relief to the residents who need it most through a homestead exemption or circuit breaker program. Moreover, because these mechanisms are state-financed, local public services will not be at risk.

Homestead exemption programs, as the name suggests, exempt a certain amount of the home's value from taxation, thereby reducing the total amount of property taxes owed. For instance, Maine's homestead exemption program exempts $13,000 of the home's value from taxation. Since the exemption amount represents a higher proportion of the value of inexpensive homes (e.g., $13,000 is 10 percent of a home worth $130,000, but only 1 percent of a home worth $1.3 million), homestead exemptions provide the greatest relief to those most in need.

Almost every state has some sort of homestead exemption program, but many of these programs have not been changed for a number of years. States can strengthen their programs by increasing the exemption amount and/or broadening the eligibility requirements.

Property tax circuit breakers limit the percentage of a household's income that the household should be expected to pay in property taxes.[41] Households whose property tax payments exceed that limit get a rebate from the state for some or all of the difference. Because they explicitly tie tax relief to household income, circuit breakers are even better targeted than homestead exemptions to the people who need them most.

In addition, circuit breakers offer an effective way to address increases in property taxes. A family that did not initially qualify for the circuit breaker can become eligible if its property taxes increase but its income does not; such a family could qualify for a rebate that offsets part or all of the increase.

Lastly, circuit breakers often provide property tax relief not only to homeowners, but also to renters, a disproportionate number of whom are low-income families.[42] While renters do not explicitly pay property taxes, landlords generally pass along a substantial portion of their property taxes in the form of rents payments.

[41] These programs are called circuit breakers because like the electrical devices that shut off electric power to prevent circuits from overloading, they prevent property taxes from "overloading" a family's budget by "shutting off" property taxes once they exceed a certain share of the family's income. For more information, see Karen Lyons, Sarah Farkas and Nicholas Johnson, "The Property Tax Circuit Breaker: An Introduction and Survey of Current Programs," Center on Budget and Policy Priorities, March 21, 2007, www.cbpp.org/3-21-07sfp.htm

[42] According to the 2005 American Housing Survey, 31 percent of all households are renters, but 57 percent of *poor* households are renters. Table 2-1, 2005 American Housing Survey, US Census Bureau, www.census.gov/prod/2006pubs/h150-05.pdf.

Currently, 18 states have circuit breaker programs, but in eight of these states only senior citizens and people with disabilities can qualify. These 18 states can strengthen their programs by lowering the percentage of income a household is expected to pay in property taxes and by broadening eligibility requirements. For instance, programs could be offered to people regardless of age, and income ceilings could be raised to allow more middle-income families to participate. The remaining 32 states have the opportunity to design a circuit breaker based on the needs of their residents.

Homestead exemptions or circuit breaker programs are typically financed by the state. Using the broader state revenue base to pay for property tax relief preserves localities' ability to provide an adequate level of services.

Conclusion

Severe caps on property taxes do not change the rapidly rising costs facing localities. In many circumstances, they do not allow local governments to continue their current level of public services, much less make any improvements demanded by residents. While localities may be able to delay or lessen the severity of cuts in public services by passing overrides or increasing their reliance on other revenue sources, these actions are also fraught with problems. A better way to provide property tax relief is to adopt or expand a homestead exemption or circuit breaker program.

Appendix
Property Tax Revenue Caps

State	Applies to	Growth	Details
Fixed Percentage (5% or less)			
Arizona	Counties, cities, towns, and community college districts	2%	Counties, cities, charter cities, towns, and community college districts cannot levy taxes in excess of 2 percent over maximum allowable amount in prior year. Limit may be exceeded by popular vote.
Idaho	Counties, municipalities, and schools	3%	Local taxing district property tax revenue is limited to 3 percent annual increase. This limitation does not apply to new construction or annexations or to voter-approved increases.
Kentucky	Counties, municipalities, and schools	4%	Rollback provision. After annual reassessment, tax rate must be adjusted to limit growth in revenue to 4 percent over prior year. Excludes growth from new property. If revenue increases more than 4 percent, voters may petition for referendum to reconsider rate.
Massachusetts	Municipalities	2.5%	Local taxing districts cannot increase total real and personal property taxes by more than 2.5 percent from the previous year's total allowable property taxes (levy limit). In addition, local taxing districts cannot levy more than 2.5 percent of the total full and fair cash value of all taxable real and personal property (levy ceiling). A local taxing district cannot raise more than the levy ceiling or the levy limit (whichever is less). The levy limit does not pertain to new property growth or to higher allowable property taxes approved by voters. Moreover, a community can assess taxes in excess of its levy limit or its levy ceiling through debt exclusions and capital outlay expenditure exclusions.
West Virginia	Counties	3%	Property tax revenues for each county generally cannot increase by more than 3 percent annually because of higher assessed property values (levy rollback). This does not apply to bonded indebtedness, new construction, additions to existing property, or excess levies. Moreover, counties and municipalities can hold a public hearing to raise property tax collections generally up to a 12 percent annual increase as long as they conform to the current levy limit, which stipulates that residential property tax rates cannot exceed \$1.00 per \$100 of assessed value. The state legislature can increase property taxes for school purposes beyond the levy rollback through a public hearing as long as it too conforms to the current levy limit.
Based on Inflation			
Colorado	Counties, municipalities, and schools	Inflation plus annual local growth	There are both constitutional and statutory restrictions on property tax revenues; whichever is most restrictive takes effect. The constitutional restriction —TABOR — limits increases to inflation in the prior calendar year plus annual local growth, adjusted for property tax revenue changes approved by voters after 1991. The statutory restriction limits revenue increases to 5.5 percent, with certain exceptions such as increased revenue from new construction and annexations.
Montana	Counties and cities	One-half the average inflation rate for the prior 3 years	Total property tax revenues collected by county or city taxing districts can increase by no more than one-half of the average inflation rate for the prior three years. Increases beyond that are allowable only with voter approval or for certain emergencies. This limitation does not apply to new construction.

State	Applies to	Growth	Details
Michigan	Counties, municipalities, and schools	Inflation	Local property tax rates must be reduced so that total property taxes in a taxing district do not increase more than the inflation rate. This limitation can be removed with voter approval, and does not pertain to property additions or improvements (local growth) or to bonded indebtedness.
Lesser of Fixed Percentage or Inflation			
California	N/A	N/A	Growth in assessed property values for individual property owners cannot increase by more than 2 percent or the inflation rate (whichever is less). Property tax rates cannot exceed 1 percent of assessed value (this does not include bonded indebtedness).
Illinois	Counties, municipalities, and schools	Lesser of 5 percent or Inflation	Some taxing districts cannot annually increase total property taxes by more than the inflation rate or 5 percent (whichever is less). In general, this limitation does not apply to improvements, additions, or to bonded indebtedness. Voters can override this limitation.
Missouri	Counties, municipalities, and schools	Lesser of 5 percent or Inflation	Property taxes for local taxing districts (or political subdivisions) cannot increase annually by more than 5 percent or the inflation rate (whichever is less). This revenue limitation percentage applies only if total assessed property valuations increase by at least that same percentage. This limitation does not apply to property additions and improvements or to bonded indebtedness. If the current property tax rate is less than the rate necessary to achieve a 5 percent or inflation growth in tax revenue, then the current tax rate is used, resulting in a lower growth rate in tax revenues.
New Mexico	Counties, municipalities, and schools	Lesser of 5 percent or Inflation	Property tax revenues from local taxing districts cannot increase annually by more than 5 percent or inflation (whichever is less). This limitation applies to existing properties but not to additional properties, improvements, or debt.
South Dakota	Municipalities and counties	Lesser of 3 percent or Inflation	All taxing districts (except school districts) are capped as to what they can ask from the tax rolls. The cap equals what was payable the previous year plus a percentage increase due to growth or new construction and percentage increase in the Consumer Price Index (CPI) with said increase up to but not exceeding 3 percent. These taxing districts may increase over this limitation, but only by a resolution of the governing body, which is referable by the local taxpayers.
Washington	Municipalities and counties	Lesser of 1 percent or Inflation	Property taxes collected for all non-school taxing districts cannot increase annually by more than 1 percent or inflation (whichever is less). However, for districts with a population of fewer than 10,000, property taxes collected cannot increase annually by more than 1 percent. These limitations do not pertain to new construction or bonded indebtedness and can be removed with voter approval.

Source: David Baer, "State Programs and Practices for Reducing Residential Property Taxes," AARP, May 2003; Center for Urban Policy and the Environment at Indiana University, "Tax and Expenditure Limits on Local Governments," U.S. Advisory Commission on Intergovernmental Relations, March 1995; and various state statutes websites.