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Rethinking Property Tax Reform

A series of policy briefs on Washington State's property tax | November 2007

I. From hack-and-slash to adequacy and equity

The Washington State property tax funds local needs that people care about.

Over half of property tax revenues go to public schools (including the state levy, which is dedicated to education). The remainder of the revenue funds local services including fire protection, emergency medical services, roads, parks, libraries, and so on. These services rank high in surveys of public priorities.

Broad tax caps should not be the goal of property tax reform

The conversation about property taxes has generally focused on cutting and controlling them. This is a very one-sided approach that has harmed the ability of local governments to provide for their residents. At the same time, these policies have done little to ensure that property taxes are affordable for moderate income homeowners.

Property tax reform should balance adequacy and equity

It is time to replace the "hack-and-slash" policies with a committed effort to balance two essential components of sound fiscal policy:

1. **Adequacy**: Does the system produce adequate revenue to fund the services it is designed to pay for?
2. **Equity**: Is the system fair, balancing taxation according to individuals' ability to pay? Does it exacerbate or alleviate inequities existing in the general economy?

Benefits of a balanced approach

By combining these principles when making decisions about property tax policy, we can:

- Provide sufficient revenue to local governments so that we can enjoy the schools, roads, fire departments, law enforcement, and civic and cultural richness that we expect in Washington State.
- Protect lower- and moderate-income homeowners from high property tax bills that would exacerbate tight budgets and increased housing costs.
- Avoid severe measures taken in other states after policymakers were unresponsive to the very real concerns people feel about property taxes.

II. Washington State's property tax caps

State law caps the growth in property tax levies.

Prior to the enactment of Initiative 747 in 2001, regular levies were restricted to growing at no more than inflation, with a cap of six percent. Initiative 747 reduced the growth limit to one percent. This arbitrary limit is well below the growth needed in order to keep up with the cost of providing public services.

Under certain conditions, the public can vote to allow the regular levy to grow above the rate limit, but cannot go above the overall growth limits (see below).

Property tax rates are also limited.

In addition to the restriction on levy growth, there is also a set of restrictions on tax rates. Local governments (cities, counties, fire districts, etc.) cannot raise a combined levy that is greater than 0.64 percent of local property value. Because of I-747, local governments are often unable to levy at the maximum rate.

A supermajority of voters are able to raise their taxes above the rate cap for up to six years. Over 90 percent of these "special" levies are for school districts, which have no regular taxing authority. (School districts can now raise special levies with a simple majority vote due to the passage of Referendum 4204).

Statewide property tax growth has been modest . .

Between 1995 and 2005, property tax revenues grew more slowly than the growth in property value. Revenues grew at roughly the same rate as the growth in personal income, a standard measure of the state economy.

. . . but individual property tax bills can still be high.

The caps on rates and levy growth affect the size of the levy, but the distribution of levies is determined solely by property value. Simply put, a more expensive house will receive a higher tax bill than a less expensive house. The result is that while the size of the total levy may be capped at one percent, individual tax bills may rise by more or less than one percent.

For example, in 2007, Jack's house was worth 10 percent more than it was the previous year, while the value of Jill's house stayed the same. Jack's property tax bill likely rose by well over one percent, while Jill's could have even fallen.

Moderate-income homeowners are not protected from unaffordable property tax bills.

Individual property tax bills may also seem high to a homeowner because the calculation of an individual tax bill does not take into account an individual's ability to pay. For example, if Jack and Jill owned homes that were worth the same amount, they would each pay the same property tax even if Jill earned five times as much as Jack.

Currently, homeowners among the richest one-fifth of Washingtonians pay, on average, less than three percent of their income in property taxes. Homeowners among the bottom 40 percent pay about six percent of their income in property taxes.

III. The ill effects of property tax caps

Levy growth caps do not account for the growing cost of providing public services.

Before I-747 was thrown out, Washington's one percent limit was the lowest in the country. Most other states with caps link the maximum growth to a measure of consumer inflation. These caps do not account for the rising cost of providing public services.

Cost increases are often outside of local government control

Much of the cost pressure faced by local government is outside of their control.

The rising cost of employee health insurance is faced every level of government as well as the private sector. The problem may be worse for local governments because local services (especially education) tend to be labor-intensive.

In addition, population growth among the elderly and school-age children is projected to grow more quickly in coming years, raising the cost of keeping current commitments in education and health.

Property tax caps have resulted in service cuts in other states

A number of states have enacted various types of limits on property taxes. The evidence is clear that the quality of public structures in these states has deteriorated as a result. For example:

- Per-pupil spending in public schools has fallen dramatically under California's Proposition 13.
- A number of towns in Massachusetts have had to lay off fire fighters and police officers, close libraries and senior centers and strictly limit infrastructure projects.

The impact of I-747 will grow

The effect of I-747 has weighed more heavily on some areas of the state more than others, but the full statewide effect has so far been dampened by voters' willingness to pass levy lifts, a booming housing market, and "banked" taxing capacity that some districts have been able to access (because of lower taxes in the past). In addition, some local governments have been able to shift to the more volatile and regressive local sales tax.

As the housing market cools and districts run out of banked capacity, I-747 will begin to have a greater impact.

Overreliance on voter approval of property tax increases is problematic.

Most states with property tax caps, including Washington State, allow voters to override the caps. Evidence from other states suggests that too much dependence on voter overrides can:

- Create inequities in public service provision between communities.
- Require costly and time-consuming campaigns.

Washington State can lower tax bills without jeopardizing local services

Policies such as property tax "circuit-breakers" have been used in other states to reduce the property tax bills of households with lower and moderate incomes without cutting the revenue available for public safety or transportation. Such programs already exist in Washington State for lower-income retirees.

IV. A property tax circuit breaker

A circuit breaker would make the property tax more equitable.

Just as a circuit breaker in a home protects the electrical system from an overload, a property tax circuit breaker would protect homeowners from a property tax bill that is too high relative to their household income.

Under such a policy, a homeowner could apply for a refund of the portion of their property tax bill that is over five percent of their income.

The Budget & Policy Center estimates that a circuit breaker would provide a 12-15 percent tax cut to homeowners among the bottom 40 percent of Washingtonians by income.

A circuit breaker would provide a transparent response to the needs of taxpayers.

The circuit breaker is unique among the options to make property taxes more affordable because it is highly visible: eligible taxpayers receive checks in the mail to offset their property tax bill.

A circuit breaker would not jeopardize local services.

A well-designed circuit breaker would not reduce revenue for local government. A circuit breaker providing up to a $1,000 break in property taxes would marginally raise the overall tax rate. The owner of a $1,000,000 property would only see a $180 in property taxes. On average, the state's wealthiest homeowners would see a two percent increase in their tax bill.

The circuit breaker would be administered at the state level, not placing any new burden on counties.

A circuit breaker should be available broadly, even to renters.

Currently, Washington State provides property tax reduction programs for low-income retirees only. Other low-income households and even moderate income households have trouble paying property taxes. The circuit breaker structure allows the program to be targeted to those who most need assistance without setting strict eligibility requirements.

Renters pay property taxes as well, albeit indirectly through increased rental payments. Since lower income households are much more likely to rent than higher-income households, extending the circuit breaker to renters would do more to balance the overall tax system.

Eighteen other states have circuit breakers.

- The circuit breaker is available to families and individuals regardless of age or disability status in 10 states.
- Circuit breakers are available to both homeowners and renters in 16 of the 18 states and to renters only in Oregon.
- Some states extend the circuit breaker only to taxpayers with very low incomes, while others extend their program to middle-income families as well.
- Nine states administer their circuit breakers through a process that is separate from their income tax system, an important point since Washington State does not have an income tax.

V. Homestead exemptions

Homestead exemptions are more valuable to lower-income homeowners than wealthier households.

Generally, a homestead exemption exempts a certain amount of a home from property taxes. While most proposals offer the exemption to all homeowners, the tax cut is more valuable to lower-income homeowners because the savings represents a larger share of their income and the tax bill they would otherwise pay.

The Budget & Policy Center estimates that a $50,000 homestead exemption would provide a 10-12 percent tax cut to homeowners among the bottom 40 percent of Washingtonians by income.

However, homestead exemptions are not as precisely targeted as circuit breakers. The result is that homeowners with higher incomes will also receive significant tax cuts, even if their tax bills are well within their ability to pay.

A homestead exemption would cut local tax revenue.

Like the circuit breaker, a homestead exemption would require an overall tax rate increase. Since the homestead exemption is available to all homeowners, the tax rate increase would be larger and shift more taxes onto non-residential property.

Because of rate caps, many local governments would be unable to levy the higher rates. The total loss of local revenue from a $50,000 homestead exemption would be over $70 million. Instituting a homestead exemption that would not harm local services would require an adjustment to local rate caps.

In addition, it is likely that the administration of a homestead exemption would fall on each county rather than a single state agency, requiring more administrative expense and placing a new mandate on strapped local governments.

VI. Property tax deferral programs

Tax deferrals can provide temporary stability to household finances.

A property tax deferral is similar to a home-equity loan that is financed by the state and due upon sale of the home. When homeowners are faced with short-term financial problems, a property tax deferral may be a viable alternative to other types of loans or financial assistance and may be useful in smoothing over a period of unemployment or unforeseen costs.

Tax deferrals do not cut taxes.

Tax deferral programs do not make the system more equitable in the long run. Lower-income homeowners will still pay a higher share of their income in property taxes.

The details of tax deferral proposals are important.

Generally, tax deferral programs have low participation rates. In part, this is likely a lack of awareness or misunderstanding of the programs. However, the details of the program can severely lessen its usefulness for strapped homeowners or even make the program unavailable to many of those with unaffordable property tax bills. For example, tax deferral programs may feature:

- Strict eligibility guidelines that keep the program unavailable to moderate income households.
- High interest rates that disadvantage the program relative to other options or can result in unaffordable payments upon sale of the home.
- Caps on the amount of property taxes that can be deferred.
- Requirements that homeowners have significant available equity.