

Local Government Revenue Growth and Property Tax Increases

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Under Montana law (MCA 15-10-420) local governments are capped in the degree to which they can raise revenue from property taxes. Specifically, tax revenue from existing property may increase from one year to the next by a percentage equal to one half the average rate of inflation over the prior three years. Every year the Department of Revenue certifies to local governments the taxable value of all the existing property in their jurisdictions (property added to the tax base in the current year is excluded), and the local governments use that information and the revenue allowed under the cap to calculate maximum permissible mills. These mills can then be applied to newly added property to generate additional revenue.

The revenue cap was intended to restrict the growth of local property taxes, and local governments and perhaps many legislators believe that they are successful in doing that. From the local governments' perspective this "success" is a mixed blessing, because it limits their ability to raise revenue and balance budgets. Indeed, the revenue caps appear to be deliberately designed to force budgets to grow at less than the rate of inflation, and evidently strict application of the revenue cap implies that real (i.e. inflation adjusted) local government spending must decline over time.* Local governments and their organizations (Montana Association of Counties and Montana League of Cities and Towns) frequently advocate in the legislature for their being granted the authority to raise revenue from other tax types, given the restriction on property tax growth.

It should be noted that the growth of property tax revenue for schools is not subject to the limitations set out in MCA 15-10-420, but school districts are constrained by the school funding system in the amount of revenue they can raise without a voted levy.

Given the intent of the law, and local governments' claim that it does indeed seriously restrict revenue growth, it is surprising to observe the frequency with which individual residential property taxpayers claim (correctly) that they have been subject to very large increases in property taxes on their homes. These increases are of course not popular, and at times are even thought to be unsustainable or to reach crisis proportions, as when they threaten to "tax people out of their homes." This means not only does the revenue cap limit the *legal* authority of local governments to raise property taxes, but increasing residential property taxes in some cases produce real hardship for taxpayers and make raising revenue through the property tax politically difficult as well.

Under these circumstances, the question becomes the following: If the legislature has effectively capped local government revenue growth at a relatively low level, why are individual homeowners experiencing very large increases in their tax bills?

There are a number of factors that explain this apparent disconnect. They are described below.

* This is not completely true. Local government spending can increase more rapidly than inflation if enough new property is added to the tax rolls

Exceeding the Revenue Cap

Because the revenue cap does not apply to all the levies that local governments can impose, local governments can and do raise revenue at significantly higher rates than MCA 15-10-420 would allow.

For example, revenue from *voted levies* to pay for general obligation bonds is not included under the cap. In Missoula (city, county and school district) voters in the recent past have elected to tax themselves for bonding to pay for acquisition of open space, new schools and school improvements, a regional park, a new library, and a variety of other public investments. The fact that the imposition of additional mills results from a voted levy may make higher tax payments more palatable to some taxpayers, but others (typically those, often the elderly, who don't believe they will benefit from parks or schools or whatever) find them onerous and resent what they regard as being run over roughshod by the majority of voters. Whether voted levies are thought of as being imposed on the public by the local governing body or by the public itself is evidently a subjective matter. Obviously, local government cannot impose such levies unless the public agrees to allow it. On the other hand, the issue typically would not come before the public unless the local government put it there.

A second significant way in which local governments can exceed revenue caps is through the formation of special districts that adopt what were formerly general government functions. In Missoula, for example, the city has formed districts to take on the management and financing of both parks and roads. Levies to pay for the operation of such districts are not subject to the 15-10-420 revenue cap, so the amount by which revenue for these functions can be increased is not limited by law, and the capped revenue that is available for general government operations obviously goes farther when these functions are removed from the general budget. For example, removing roads from the general operating budget and levying for them separately means that there is now more general government revenue available for, say, the police department. This will provide some budgetary relief, but eventually, as police department costs rise at the rate of inflation and revenue to meet those costs rises at half the rate of inflation, a budgetary shortfall will recur.

Finally, state law allows for levies for certain specified purposes, e.g. health insurance costs, to be increased with no cap.

It is also important to note that even if revenue from levies on existing property increase at the statutorily limited rate (half the rate of inflation), the addition of newly taxable property to the tax base will generate additional revenue. Indeed, increased revenue from this source may well exceed the increase in revenue allowed under MCA 15-10-420. For the city of Missoula, for example, the allowable increase in revenue from existing properties between tax years 2018 and 2019 was .83%, while the addition of newly taxable property expanded the tax base by 1.4%. Expansion of the tax base then accounted for significantly more revenue growth than did increases in tax rates.

The amount by which revenue growth can exceed the cap can be fairly large. For example, between 2012 and 2018, the city of Missoula reported growth in total taxes and assessments of 24.8%. Had revenue growth been restricted to half of the rate of inflation over this period, this figure would be 5.2%. Unfortunately, the available data do not allow the difference in these two rates to be decomposed into fractions attributable to voted levies, uncapped levies, and additions of newly taxable property.

Shifting the Tax Base

Taxes on class 4 residential properties will increase more rapidly than local government tax revenue in general if the taxable value of such residential property rises with respect to the taxable value of the entire tax base, i.e. if the tax base shifts to class 4 and the share of the tax base consisting of residential property grows over time; or stated the other way around, if the share of the tax base consisting of non-residential property declines over time. Why that might happen is discussed below.

But first, let r represent the relative increase in local government tax revenue over some period of time and let g and g_R be the relative increase over the same period in the taxable value of all property and residential property respectively. Then the relative increase in the taxes paid by residential properties, t , is given by the following expression:

$$t = r(1 + G_R) + G_R$$

where $G_R = [(1 + g_R)/(1 + g)] - 1$.[†]

By way of a numerical example, between 2008 and 2018, the total taxable value of residential property in the city of Missoula grew by a factor of .484 while the total taxable value of all property grew by a factor of .348. These are the values of g_R and g in the expression for G_R , and they yield a value for G_R of .101. What this means is that even if total tax revenue in the city had not increased at all over the period, the differentially greater growth of residential property would have caused total residential property taxes to rise by 10 percent, or about one percent per year. In addition to that effect, for every one percent increase in total city tax revenue, taxes on residential property increased by 1.1 percent. Thus if total tax revenue in the city increased by, say, 30 percent over the period, total taxes on residential property would increase by 43 percent ($1.1 \times 30 + 10$) with the difference of 13 percentage points being attributable to differentially higher growth in the taxable value of residential property (or differentially lower growth, including, possibly, decline, in the taxable value of non-residential property).

It is important to bear in mind that the increased taxes on residential property (43 percent in this example) are not all imposed on existing property, i.e. on property on the rolls in 2008. On the

[†] Let T , S and R be the beginning values of taxes paid by residential property, the share of the tax base in residential property, and total tax revenue respectively, so $T = SR$. Let T' , S' and R' represent the values of the same variables at the end of the period, and indicate the change in any variable over the period with Δ so that, for example, $R' = R + \Delta R$. Then $\Delta T = S'R' - SR = (S + \Delta S)(R + \Delta R) - SR = S\Delta R + R\Delta S + \Delta S\Delta R$. Let $\Delta T/T$ be t , then $t = \Delta R/R + \Delta S/S + (\Delta R/R)(\Delta S/S)$, or letting $\Delta R/R = r$, $t = r(1 + \Delta S/S) + \Delta S/S$. Note that $S = TV_R/TV$, i.e. the ratio of the taxable values of residential property to all properties, the relative growths of which over the period are g_R and g respectively. So $\Delta S = \{[TV_R(1 + g_R)]/[TV(1 + g)]\} - TV_R/TV = (TV_R/TV)\{[(1 + g_R)/(1 + g)] - 1\}$, $\Delta S/S = [(1 + g_R)/(1 + g)] - 1$. Substituting, $t = r(1 + G_R) + G_R$, where $G_R = \Delta S/S = [(1 + g_R)/(1 + g)] - 1$

contrary, a significant part of the increase is due to new property being added to the rolls. Because of the way in which the data is recorded and stored it is impossible to calculate the differential growth of taxable value or taxes paid (13 percent in the example) by existing residential property alone, but it's safe to assume that in the city of Missoula it is substantially less than 13 percent. That's because most of the growth in the taxable value of residential property appears to be attributable to new property being placed on the rolls rather than the average taxable value of existing property substantially appreciating. These observations lead to the general conclusion that only a relatively small, and uncertain, part of the increase in taxes experienced by residential property owners in the city of Missoula over the last decade or so is due to a shift of the tax base towards existing properties. This would be even more true of Missoula county; the value of G_i for residential property for the county as a whole is .053.

Regardless of its quantitative significance (which can obviously vary across jurisdictions), it is worth noting why the tax base might shift toward residential property.

One reason for this shift is a variety of factors that cause the taxable value of non-residential property to fall. In several instances, the legislature has changed the tax treatment of such properties, as when, for example, it exempted much of Class 9 (business equipment) property from taxation, effectively reducing its taxable value to 0. Similarly, businesses have successfully challenged the Department of Revenue's accounting rules for determining the value of centrally assessed properties, resulting in negotiated settlements that reduced those values. And finally, in some jurisdictions local governments or tribes have acquired properties that were previously privately owned and removed them from the tax base. Examples of the latter include the city of Missoula's purchase of the Mountain Water Co. and the Salish and Kootenai Tribes' purchase of Kerr Dam.

In some of these instances, provision has been made to make up for the revenue lost when the taxable value of non-residential property was reduced; for example, when the legislature exempted most business equipment from taxation, it "backfilled" the loss of revenue to local governments. It should be noted, however, that such backfilling does not stop the shift of the tax base towards residential properties, meaning that taxes paid by residential properties will still increase more rapidly than tax revenue in general.

Residential property can rise or fall in value relative to other property types due to the operation of the real estate market, but such effects are likely to show strong geographical variation. During the 2002-2008 reappraisal cycle, for example, residential properties in a handful of counties (Flathead and Gallatin are cases in point) increased in value at a rate well above the statewide average of about 52 percent. The rate of increase in other counties obviously was below average. To mitigate the impact of the 2008 reappraisal, the 2009 legislature reduced the class 4 tax rates to a degree such that the taxable value of a property that had appreciated in market value by 52 percent from 2002 to 2008 would remain unchanged. The result was that in some counties the taxable value of residential properties rose substantially, as did their share of the tax base and tax bill. In other counties, the opposite was true. The legislative adjustment of tax rates was said to under- and over-mitigate the effect of reappraisal for these two groups of counties respectively.

It is apparent that whether there is a shift of the tax base towards or away from residential property depends heavily on location. Jurisdictions vary sharply in real estate market conditions, whether or not property is being removed from the tax rolls, and in the relative importance in the

tax base of properties that receive favorable legislative or administrative tax treatment. Even at the local level, because of the way in which tax data is collected, recorded and reported, it is difficult to know how much tax shifting is occurring as the result of these various factors, but it appears reasonable to say that their effect on average residential property taxes in Missoula (both city and county) has been modest. It is worth noting, however, that the tax base in Missoula is relatively low in comparison to its population and to other cities in Montana, which probably reflects the fact that very substantial non-residential properties (notably the University of Montana, many of the Saint Patrick Hospital properties, and all Federal government facilities) are not included in the tax base. The implication of the low per capita tax base is that the city has to impose higher millage than other cities to generate the same per capita revenue.

Valuation of Individual Properties

The final factor accounting for the rapid growth of taxes on some individual residential properties is the very rapid appreciation in the taxable value of those properties relative to residential properties in general. Of particular interest in this regard are differences in the rates of growth of individual property values resulting from reappraisals performed by the Montana Department of Revenue.

Relative Change in Taxable Values and Taxes; 2008-2017;
34,181 Missoula County Residential Properties; Ranked by
Relative Change in Taxable Value; Quintiles and All Properties

Quintile	Relative change in	
	Mean Taxable Value	Mean Tax
Highest	0.396	0.700
4	0.199	0.471
3	0.097	0.336
2	0.012	0.230
Lowest	-0.158	0.022
All	0.095	0.335

Differences in the rates of growth in the taxable value of individual residential properties within a single county or city can be quite large, and lead to comparably large differences in the growth of taxes paid. The table above illustrates these differences in the rates of growth of taxable values for Missoula County for the period 2008 to 2017. These figures were derived by computing the relative change in taxable value and taxes paid for each of 34,181 residential properties that

appeared on the tax roles in both 2008 and 2017.[‡] Properties were ranked by the relative change in taxable value over the period, and the mean change in taxable value and taxes paid was computed for each quintile, and for all 34,181 properties taken together. It is important to note that while changes in taxable values reported in the table reflect the combined effect of market value reappraisals by the MDOR and legislative mitigation of the impact of those reappraisals, they are also affected by physical improvements on the properties in question, such as new construction, remodels, etc. In some cases, taxable values showed extraordinarily high growth for properties that were bare land in 2008 but were built on between 2008 and 2017. The data was trimmed in an attempt to eliminate these cases, which are not representative of the impact of reappraisal.[§]

As the figures in the table indicate, on average the properties in the sample increased in taxable value by a relatively modest 9.5% over the period, or by about 1 percent per year. But there was a good deal of variation around this mean. Thus the average taxable value of properties in the top quintile increased at about four times the overall rate, while in the bottom quintile, taxable values fell by almost 16 percent.

Disparities in the rates of growth of taxable values lead to similar large disparities in the rate of increase in taxes. Thus while the average increase in taxes across all properties in the sample was 33.5 percent, for properties in the top quintile (in terms of taxable value growth) the average tax bill grew by 70 percent, and for properties in the bottom quintile (for which taxable value actually fell) taxes increased by only 2.2 percent.** And to some degree, focusing on the disparity in quintile means understates the degree to which the extremes in individual property tax growth rates diverge. For example, the increase in the mean tax bill for the top decile was about 86 percent and would be even greater than that if the data had not been trimmed.

Finally, it is important to note that there is no evidence to suggest that the rate at which taxes on individual properties grew bore any significant relationship to either the initial (2008) value of properties or the income of taxpayers.

Conclusions

Why then are people being taxed out of their homes? The answer is a little complicated.

For one thing, there are a lot of people who are not being taxed out of their homes. As the figures in the table above indicate, from 2008 to 2017 somewhere in the neighborhood of 40 percent of Missoula county taxpayers saw their taxes go up by about 2.5 percent per year or less, barely matching the rate of inflation and less than the growth of average household income. These were the taxpayers whose properties showed little growth, or even a decline in taxable value.

[‡] The data were provided by the Montana Department of Revenue, and show taxable value and total mills levied against each residential property in 2008 and 2017. Taxes paid were imputed to each property as the product of taxable value and total mills levied.

[§] The original data set included 38,181 residential properties. The 2000 properties with the highest and lowest rates of change in taxable value were trimmed.

** Average total mills increased by slightly more than 20 percent over the period, although this increase varies from one property to another because not all properties face the same set of levies. The average percent increase in taxes is approximately equal to $TV + M + TV * M$, where TV and M are the percent increases in average taxable value and percentage increase in mills respectively.

On the other end of the scale, there were taxpayers who experienced very large and arguably, in some cases, unsustainable growth in property taxes. Several factors led to that growth. Local governments employed a variety of methods to increase revenues above and beyond the ostensible caps specified in law. Taxes were increased by the public through voted levies. And there was some shifting of the property tax base from other classes onto residential property. But by far the most significant cause of unsustainable tax increases was very large increases in the appraised values of individual properties.

One implication of this fact is that even if local governments were provided with new revenue sources (e.g. a local option tax) that allowed them significantly contain or even halt the growth of property tax levies, there would still be a large minority of taxpayers whose property taxes would continue to increase significantly over time.

If the problem of unsustainable tax increases stems from reappraisal practices, is there some way of “fixing” those practices that will make the problem go away? Unfortunately, not an obvious one.

The observation that reappraisal has, in certain instances, caused large tax increases is hardly novel. In the 2002-2006 reappraisal cycle, for example, some properties in Lake County, particularly those located on Whitefish and Flathead lakes, appreciated in taxable value at well more than 100 percent, and certainly much more rapidly than properties’ owners’ incomes grew. A common reaction from those owners was to question the Department of Revenue’s reappraisal methods. Surely, it was suspected, the Department had grossly overstated the growth of property values in the area. But subsequent analyses (price/assessment ratio studies) by independent consultants indicated that the Department’s appraised values matched closely the actual market values for which the properties subsequently were sold. There was no evidence that the Department had systematically over-appraised.^{††}

One way of containing taxable value growth is simply to throw out market based reappraisal in its entirety. This was the solution adopted by California voters when they passed the famous Proposition 13, under which the value of a residential property was allowed to grow by no more than 1 percent per year as long as it remained under the same ownership; a new value would only be assigned when the property changed hands. This scheme obviously protects owners from an increase in their tax bill as long as they stay in the same home, but creates the potential for serious inequities: two neighbors, with equal incomes and identical houses can have vastly different tax bills if one has been living in her house for, say, 15 years and the other only moved in a year ago. These sorts of inequities in valuation would probably be considered a violation of Montana’s Constitution.

Given these considerations, it appears that the appropriate way to respond to the problem of unsustainable property tax increases – which are, again, those increases that occur in no relation to the income of the property owner – is through income based property tax assistance programs. Several such programs, notably the Elderly Home Owner and Renter Credit, exist in Montana, but in general they are structured in ways that produce significant inequities and inefficiencies. Accordingly, local governments wishing to address the plight of property tax

^{††} Some properties had been over-appraised, but a roughly equal number had been under-appraised, and few of the mis-appraisals, positive or negative, were large.

payers who are arguably overburdened – typically taxpayers with low and fixed incomes – should advocate for comprehensive overhaul of the state’s assistance programs and for the creation of an assistance program based on the reality of property taxpayers’ incomes.