Property Tax Relief for Homeowners

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POLICY FOCUS REPORT LINCOLN INSTITUTE OF LAND POLICY

ABOUT THIS REPORT

This report evaluates more than a dozen common approaches to property tax relief. The authors emphasize the importance of designing relief programs to address specific challenges while avoiding untargeted measures that cause excessive revenue losses and other major unintended consequences. This more targeted approach builds on the property tax's many strengths as a local revenue source and reinforces its role as the linchpin of local government in the United States. The report concludes by recommending a package of policies that will promote a tax system that is fair and affordable for taxpayers while providing the revenue needed for quality public services.

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 information from professional practitioners, local officials, and citizens in diverse communities.

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ISBN 978-1-55844-416-4 (paper)
ISBN 978-1-55844-417-1 (PDF)

Front Cover
Sources: franckreporter/iStock (top), peterspiro/iStock (bottom).

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Contents

3 Executive Summary

6 Chapter 1 Introduction

- 7 The Property Tax Is the Foundation of Local Government
- 7 Evaluating Revenue Options for Local Government
- 11 The Need for Property Tax Revenue
- 12 Potential Challenges with Property Taxes and the Need for Relief
- 14 Property Tax Relief: The Good, the Bad, and the Ugly

15 Chapter 2 State Policies That Indirectly Affect Property Taxes

- 16 State Aid
- 18 Local Revenue Diversification
- 19 Classification
- 21 Local Government Service Responsibilities
- 22 Local Government Efficiency

24 Chapter 3 Tax Limitations

- 25 Property Tax Bills in a Budget-Driven System
- 26 Rate Limits
- 27 Assessment Limits
- 29 Levy Limits
- 31 Common Features of Tax Limits
- 32 Effects of Tax Limits

34 **Chapter 4** Property Tax Relief Programs

35 Homestead Exemptions and Credits
38 Income-Based Homestead Credits
39 Circuit Breakers
41 Deferrals
43 Key Features for Relief Programs

50 **Chapter 5** Administrative Reform

51 Quality Assessment Practices with Regular Revaluations
54 Monthly Payment Options

56 **Chapter 6** Recommendations

59 **References**

63 **Acknowledgments**

64 **About the Authors**

65 **About the Lincoln Institute of Land Policy**

65 **Ordering Information**

Executive Summary

Local governments depend on the property tax for nearly half of the revenue they raise. *Source: Sundry Photography/iStock Editorial/Getty Images Plus.*

The property tax accounts for nearly half of all revenue raised by local governments in the United States. As a funding source, it has many strengths. Its immobile tax base allows localities to assemble a package of taxes and services that reflects the preferences of their citizens. It provides stable revenue over the business cycle, promotes transparency regarding governments' fiscal decisions, and tends to impose less drag on the economy than other taxes. The property tax is also progressive compared to most alternatives; that is, it tends to take a relatively smaller share of income as incomes fall—especially when targeted tax relief options are in place, such as the circuit breakers and homestead credits discussed in this report.

Like any tax, the property tax faces challenges. Fiscal disparities across communities are a problem for any local tax and mean that poorer jurisdictions may struggle to provide adequate services at affordable tax rates. Since it does not consider current income, the property tax can be unaffordable for those who are house-rich but income-poor. In addition, property taxes can potentially increase sharply from one year to the next, may be based on inaccurate or outdated estimates of value, and often must be paid in large lump sums.

The good news is that there are policy options that can effectively address all of these challenges. When used together, they can promote a tax system that is fairer and more affordable for taxpayers while still providing the revenue needed to support quality public services. But it is important to design relief programs carefully to address specific issues, because untargeted policies can cause excessive revenue losses and have serious unintended consequences.

This report explores the strengths and challenges of the property tax as it is currently structured and administered in the United States. The report then evaluates the real-world impacts of more than a dozen common approaches to property tax relief, including state aid, local revenue diversification, rate limits, assessment limits, levy limits, homestead exemptions, circuit breakers, deferrals, assessment reforms, and monthly payment plans.

The report carefully examines the outcomes of specific relief strategies in states and localities across the country, including tax swaps in Michigan and South Carolina; tax limits in California, Massachusetts, and Wisconsin; property tax relief programs in Boston, Colorado, and Michigan; and monthly payment options in Butler County, Ohio, and Milwaukee. These case studies and relevant data help illustrate which tax relief programs are most effective, which are least effective, and why.

This report offers five key recommendations to promote an equitable and efficient tax system:

Implement quality assessment practices with regular revaluations. Accurate assessed values are the foundation of a fair property tax system.

Utilize well-designed state aid formulas. State aid is the only way to address fiscal disparities across communities and ensure that all localities have the resources needed to provide quality public services.

Provide targeted and cost-effective property tax relief with circuit breakers and deferrals. Circuit breakers provide relief when property taxes exceed a threshold percentage of income. Deferrals allow homeowners to delay payment of their tax until their home is sold or inherited.

Allow homeowners to pay property taxes on a monthly basis. Instead of requiring lump-sum payments that can create financial challenges for households and increase tax delinquency, local governments should consider alternative payment plans.

Avoid tax limitations, especially assessment limits. Tax limits are one of the most common responses to political pressure for property tax relief, but are generally a poor choice. Rather than imposing inflexible tax limits, state and local governments should facilitate well-functioning assessment and rate-setting procedures, such as the Truth in Taxation measures described in this report.

Communities across the United States rely on the property tax to support education, public safety, parks, infrastructure, and other essential services. Effective relief policies can address the challenges of the property tax and build on its strengths, increasing its fairness and reinforcing its critical role in the effective operations of local government.

Effective property tax relief can provide a fairer, more affordable system for taxpayers while still generating adequate revenue to support public services. *Sources: kali9/iStock/Getty Images Plus (top left); Cavan Images/Alamy Stock Photo (top right); monkeybusinessimages/ iStock/Getty Images Plus (bottom).*

CHAPTER 1

Introduction

The property tax is a critical source of funding for public services such as fire and rescue. *Source: poco_bw/iStock.*

The property tax is essential to the functioning of local government in the United States, with many important strengths as a local revenue source. But like any tax, it also presents challenges. Fortunately, there are many policy options that improve the operation of the tax without undermining its strengths. One crucial task for policy makers is to provide appropriate property tax relief targeted to specific issues while avoiding overly broad measures that cause excessive revenue losses and have other major unintended consequences.

The Property Tax Is the Foundation of Local Government

The property tax is uniquely suited for funding the independent local governments that play a critical role in the United States federal system. Figure 1.1 shows the vital role of local governments in funding key public services that enhance the quality of life for their residents, including K–12 education, police and fire protection, parks, infrastructure, and much more. Local governments, which include cities, counties, school districts, and all other jurisdictions below the state level, are the level of government closest to the people and most trusted by their residents (Gallup 2017). An important reason for this is the proximity and flexibility that allow local governments to understand and respond to the needs of residents.

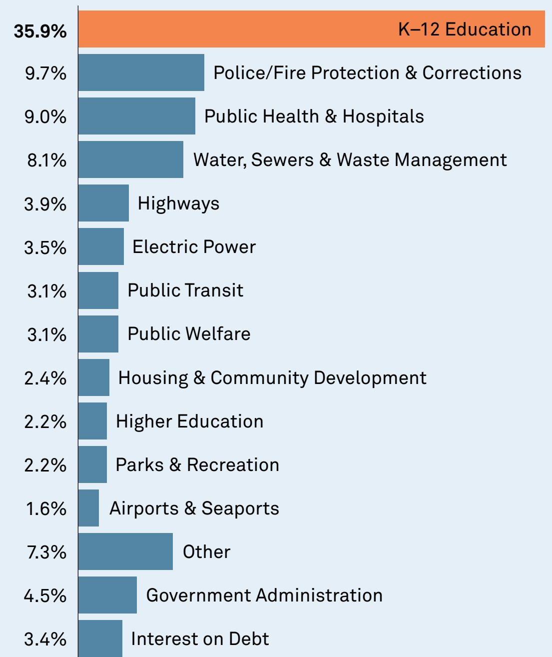
But independent decision making also requires that local governments have the ability to raise and manage sufficient revenues to fund their operations. Local control allows residents some ability to choose the mix of revenues and expenditures that best reflects their own preferences, rather than a standard package of services and spending set by a central authority. Voters have a much clearer sense of the trade-offs between taxes and spending at the local level than is possible with state and federal budgets. Of course, areas in need require redistributive aid from higher levels of government. However, local autonomy in budget choices generally permits efficient budget decisions that improve residents' quality of life (Oates 2001).

Evaluating Revenue Options for Local Government

While the property tax is the primary revenue source for local governments in the United States, as shown in figure 1.2, many jurisdictions have the authority to impose income taxes, sales taxes, and/or user

Figure 1.1

Local Government Spending (2019)

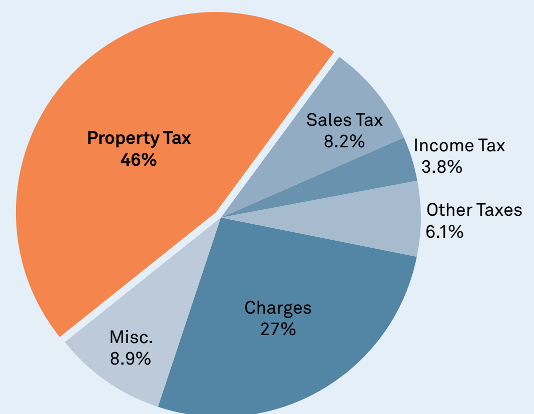


Local governments provide a wide array of public services that are critical for residents' quality of life, with more than a third of their spending directed to K–12 education.

Source: U.S. Department of Commerce 2019a.

Figure 1.2

Revenue Raised by Local Governments (2019)



Local governments raise over five times more revenue from property taxes than from sales taxes, and over 10 times more than from income taxes.

Source: U.S. Department of Commerce 2019a.

charges as well. Table 1.1 compares the three main types of taxes across several key criteria, which are explained in full in this chapter. Although the performance of each tax varies based on how it is structured and administered and each revenue instrument has strengths and drawbacks, the property tax is the best option available for most local governments.

REVENUE STABILITY

A stable revenue source reduces the risk of cuts to essential services during a recession or other economic downturn, which are often the times when the need for such services is greatest. Property taxes are generally quite stable, while income taxes are highly volatile; sales taxes occupy a middle position.

Because state governments are largely funded by income and sales taxes, economic downturns often lead to reductions in state aid to localities, further increasing the importance of a stable, independent local revenue source.

For example, table 1.2 shows that the reduction in property tax revenue during the 2007–2009 recession was far smaller than the corresponding drop in sales and income taxes. This is particularly notable because that recession saw a historic decline in

Table 1.1

Evaluating Three Tax Options for Local Governments

When considering a range of criteria, the property tax is usually the best tax option available for local governments.

Key Considerations	Property Tax	Sales Tax	Income Tax
Revenue Stability	**Best**	2nd Best	Worst
Progressivity	2nd Best	Worst	**Best**
Accountability & Transparency	**Best**	Worst	2nd Best
Tax Base Immobility	**Best**	Worst	2nd Best
Fiscal Disparities	2nd Best	Worst	**Best**
Efficiency	**Best**	2nd Best	Worst
Tax Pyramiding	**Best**	2nd Best	Worst

Table 1.2

Decreases in State and Local Taxes During Two Recent Recessions

Inflation-Adjusted Per Capita Taxes

Property taxes are a stable revenue source over the business cycle, and do not decline nearly as much as sales and income taxes during recessions, even when housing prices decline.

Source: U.S. Department of Commerce 2020.

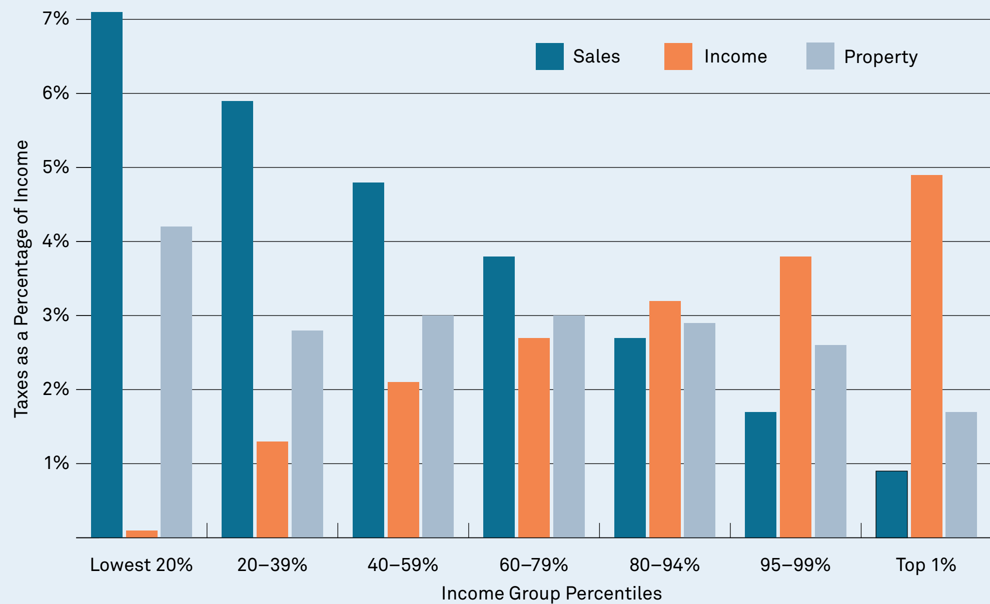
	2001 Recession			Great Recession, 2007–2009		
	Property	Sales	Income	Property	Sales	Income
% Change	**No Drop**	**-4.6%**	**-18.2%**	**-9.0%**	**-19.7%**	**-20.5%**
Peak	N/A	2000: Q4	2000: Q4	2009: Q1	2006: Q4	2007: Q3
Trough	N/A	2003: Q1	2003: Q2	2013: Q1	2011: Q3	2010: Q2

Notes: Real per capita taxes calculated using CPI-U (end of quarter) and Total Population (end of quarter). Data are available from FRED (series are CPIAUCSL and POP): fred.stlouisfed.org.

Figure 1.3

State and Local Taxes as a Percentage of Family Income (2018)

Property taxes account for roughly the same share of family income across most of the income distribution, while sales taxes are highly regressive and income taxes are very progressive.



Source: ITEP 2018.

housing prices. Similarly, property tax revenues also held up better than income and sales taxes in 2020 when COVID-19 initiated a recession (U.S. Department of Commerce 2020). Because state governments are largely funded by income and sales taxes, economic downturns often lead to reductions in state aid to localities, further increasing the importance of a stable, independent local revenue source.

PROGRESSIVITY

A progressive tax is one that takes a larger *share* of income as income rises. A proportional tax takes the same percentage of income across all income levels, and a regressive tax takes a declining share of income as income rises. Figure 1.3 shows that the *initial incidence* of taxation (in other words, the impact on those paying the tax bill) is highly progressive for state and local income taxes and highly regressive for sales taxes. Property taxes are flat or proportional across most of the income distribution, although tax relief might be needed to avoid imposing higher tax burdens on the lowest-income households (see table 1.3, page 12). The *ultimate incidence* of taxation (which parties bear the economic burden of the tax) depends on how the tax may lead to changes in prices, wages, rents, and asset values. While there is some disagreement on the ultimate incidence of the property tax, most economists believe it to be proportional or progressive overall because it reduces returns to capital that largely flow to higher-income households (Fisher 2016).

ACCOUNTABILITY AND TRANSPARENCY

Governments make better fiscal decisions when informed voters are aware of the taxes they pay and the services they receive. The property tax does best in this regard, because most homeowners are quite knowledgeable about how much property tax they pay each year. The sales tax is the least transparent, because it is collected in numerous small transactions that are never totaled over the course of a year. The income tax lands in the middle, because payroll withholding obscures the ultimate amount payable for many households.

TAX BASE IMMOBILITY

The relative immobility of a tax on real property is a key strength for local governments. Because land is completely immovable, local voters can choose a package of taxes and services without concern

More stable than the sales tax or income tax, the property tax is a reliable source of revenue that supports the management and maintenance of municipal parks across the country, including Scissortail Park in Oklahoma City. *Source: Hargreaves Jones.*

that small tax differentials with neighboring jurisdictions could drive away this portion of the tax base. Buildings are a long-term investment, slow to respond to small tax advantages or disadvantages. By contrast, shoppers will drive across county or even state borders to obtain lower sales tax rates, greatly restricting the ability of local governments to make independent decisions on this tax. The income tax falls in the middle: although the locations of businesses and residences are long-term investments influenced by factors such as the local quality of life, sharp differences in income-based tax rates, including wage taxes, can drive away mobile businesses and residents.

FISCAL DISPARITIES

Property taxes are sometimes criticized on the grounds that low property values in distressed communities cannot support adequate services at affordable tax rates. However, this is not a property tax problem but a local tax problem, because such areas require redistributive aid from higher levels of government. In fact, most research shows that tax base disparities are *larger* for sales and payroll taxes than for the property tax, while the income tax base is the most evenly distributed (McGuire 2001; Oates and Schwab 2004; Sjoquist and Stephenson 2010; Zhao 2010). Communities with little or no commercial activity could not fund their operations through sales taxes alone, and some jurisdictions, such as agricultural areas, may have a low or erratic income tax base.

EFFICIENCY

Tax design should seek to raise revenue with as little loss of economic activity as possible. Almost all taxes influence decisions in ways that reduce economic welfare to some degree. A well-known historical example is the window tax in Great Britain. When it was introduced in 1696, the number of windows was considered an index of property value, but for over 150 years the existence of the tax led many property owners to brick over their windows and to construct buildings with as few windows as possible, with very serious adverse health effects (Oates and Schwab 2014). A tax on land value is unique among taxes since it does not distort behavior, because the supply of land is fixed and cannot be increased or reduced in response to a tax (Dye and England 2010). Taxes on buildings do incur efficiency losses, but research shows that the combined property tax on land and buildings is still the most efficient tax, followed by the sales tax, the personal income tax, and finally the corporate income tax (Johansson et al. 2008).

TAX PYRAMIDING

It is important to analyze local taxes in the context of state and federal tax systems. Adding a local income or sales tax on top of federal and state taxes can push the combined tax rate to levels that cause greater public opposition and harm to economic growth. In contrast, very few state governments impose a residential property tax. Since the efficiency costs of a tax rise exponentially with the total tax rate, there are benefits to having local governments rely more on property taxes while states rely more on income and sales taxes (Oates 2001).

A WORD ABOUT CHARGES

User charges are an important revenue source, contributing far more to local budgets than sales or income taxes. Appropriate charges for services such as water delivery or garbage collection can promote efficient use of public resources. Charges can also reduce the need for taxes that distort economic decisions, and often there is strong public sentiment that users should contribute to the cost of services. However, charges can be quite regressive, taking a declining share of income as income rises, and must be designed to avoid restricting access to vital services by low-income households.

The Need for Property Tax Revenue

The fiscal outlook for state and local governments underscores the importance of getting property tax relief right. A host of challenges facing state and local governments highlights the necessity of implementing tax relief policies that address specific concerns without unduly diminishing revenue.

Most local governments face rising costs, including unfunded pension liabilities, other post-employment benefits (OPEB), and deferred infrastructure maintenance. At the same time, rising health-care costs are affecting employee payrolls, Medicaid, and other government health services (Langley 2014). Many jurisdictions also face political and legal pressure to increase spending on education (Farmer 2018; Goldstein 2018). Taken together, these rising costs are likely to require increasing revenue to maintain current service levels.

With similar long-term pressures at the state and federal levels, it is unlikely that intergovernmental aid will make up this shortfall. In fact, many localities may face reduced grants and transfers from higher levels of government. Although taxation of online sales has provided a boost to collections, the sales tax base has undergone steady, long-term erosion from the shift to a service-based economy.

There has also been a long-term increase in the residential share of the overall property tax base. This means that homeowners could face rising tax bills even if total collections remain stable (Gravelle and Wallace 2009). This trend is driven by changes in the economy, with growing service and knowledge sectors that utilize far less real estate than traditional manufacturing, and growing health and education sectors that are largely tax exempt. Competition for jobs has also led many local governments to offer business tax incentives as a means of attracting new employers (Kenyon, Langley, and Paquin 2012).

A host of challenges facing state and local governments highlights the necessity of implementing tax relief policies that address specific concerns without unduly diminishing revenue.

Finally, it is especially important to provide property tax relief that is targeted and cost-effective during recessions. At these times, job losses increase the need for property tax relief even as fiscal pressures facing state and local governments limit the resources available for it.

Potential Challenges with Property Taxes and the Need for Relief

While the property tax is the best revenue option for most local governments, it also presents challenges, as seen in table 1.3. Fortunately, there are policy options to address each of these concerns, all of which will be discussed in this report. It is essential that public officials take care to avoid policies whose unintended consequences can create new problems.

FISCAL DISPARITIES

As described earlier, fiscal disparities affect any local tax, with wealthier districts able to raise more revenue than poorer areas, even with lower tax rates. Again, this is not a property tax problem, but a problem for all local taxes. Areas that have limited tax capacity require aid from higher levels of government, not a different local tax. Circuit breakers and other state-funded property tax relief can also help mitigate these disparities, since residents in poorer communities tend to receive more relief under these programs.

Table 1.3

Potential Problems with the Property Tax and Promising Solutions

Potential Problems	Promising Solutions	Policies to Avoid
Fiscal disparities: Poorer jurisdictions may struggle to provide adequate services at affordable tax rates	**State aid** Circuit breakers	Tax limits Tax swaps
Perceived regressivity: Belief that lower-income households pay a higher share of income in property taxes	**Circuit breakers** Income-based homestead credits Homestead exemptions and credits	Tax limits Classification
Liquidity constraints: Some homeowners are housing-rich, but income-poor	**Deferrals** **Circuit breakers**	Assessment limits
Volatility: Potentially sharp year-to-year increases in taxes, especially after reassessment	**Regular revaluations** Phase-ins Truth in Taxation Circuit breakers Deferrals	Assessment limits
Inaccurate assessments: Estimated property value is inaccurate or contested	**Quality assessment practices** **Regular revaluations**	Tax limits
Salience: Property tax is highly visible and paid in large lump sums	**Monthly payment options**	Tax limits
Tax levels: Property taxes for the *average* homeowner are too high, not just for *individual* homeowners	**State aid (well designed)** **Homestead exemptions and credits** **Increases in local government efficiency** **Truth in Taxation** Levy limits Local revenue diversification	State aid (poorly designed) Classification Decreases in local government services Assessment limits

Note: For each potential problem, the most promising solutions are in bold.

PERCEIVED REGRESSIVITY

The property tax is often criticized as regressive, although, as explained above, many economists consider it to be proportional or progressive overall (Fisher 2016). While there is debate about the incidence of the tax, there is no doubt that targeted tax relief, such as the circuit breakers and homestead credits discussed in chapter 4, can make the distribution of the tax burden more progressive and compensate for any difficulties in accurately assessing lower valued properties.

LIQUIDITY CONSTRAINTS

As an asset tax not necessarily related to current income, the property tax can create liquidity problems for taxpayers whose home value is not matched by their cash flow. This can be a long-term situation, as in the case of senior citizens on fixed incomes or homeowners with low incomes in gentrifying areas with rapidly increasing housing values. Other taxpayers may face a short-term cash flow problem when dealing with temporary situations such as job loss or emergency expenditures. Property tax deferrals can assist taxpayers who have sufficient home equity to serve as collateral, and circuit breakers can help with both short- and long-term liquidity challenges.

VOLATILITY

Sudden and unexpected increases in property tax bills are another potential problem. These are often the result of long-delayed revaluations, and regular reassessments greatly reduce the likelihood of rapid spikes in tax liabilities. Large adjustments that follow a long period without reassessment may need to be phased in over a number of billing cycles. As discussed in chapter 3, Truth in Taxation measures help avoid "silent" tax increases during periods of rising values. This is critical, because almost all property tax revolts have occurred when rapid price appreciation led to spikes in property taxes (Fisher, Bristle, and Prasad 2010). Finally, circuit breakers and deferrals can help homeowners who struggle with tax payments after a dramatic increase.

INACCURATE ASSESSMENTS

While most taxes are based on measurable economic activity, such as income or sales, property taxes reflect an estimate of real estate values. Outdated or inaccurate assessments can give rise to arbitrary and unfair tax liabilities. It is vital that assessors utilize modern, computer-based assessment techniques, revalue property on a regular basis, and provide access to formal and informal appeals processes to resolve disputes. A market-value tax base itself improves accuracy by helping taxpayers to understand their assessments, and consequently to identify errors. Effective administration is the key to benefiting from the strengths of the property tax.

SALIENCE

Many observers believe that the high visibility of the property tax leads to political unpopularity (Cabral and Hoxby 2012). As described above, this transparency promotes accountability and improves fiscal decisions as compared with sales or income taxes, whose costs are often obscured. However, having to pay property taxes in just one or two large bills each year creates budget challenges for households that struggle to save for large, infrequent expenses. Governments can address this problem by providing the option for monthly property tax payments (Langley 2018).

TAX LEVELS

In some situations, voters and policy makers may perceive the overall level of property taxes to be too high. This is not a problem with the property tax, but part of a larger debate over the level of government spending and the mix of local revenues. Table 1.3 lists the best approaches to reducing property taxes across the board, but policy makers should consider these measures with caution. Decreasing property taxes in this way can lead to increases in other state or local taxes or to erosion in the quality of local public services.

Property Tax Relief: The Good, the Bad, and the Ugly

Over the past five decades, states have implemented a wide range of policies intended to provide property tax relief. The results show that it is critical to design these programs to target specific concerns with the property tax and to avoid sweeping changes whose unintended consequences can leave tax systems with new and more serious problems.

The good news is that there are proven options to address common issues without undermining the strengths of the property tax as a local revenue source. A package of policies that includes circuit breakers, deferrals, sound assessment and collection practices, and well-designed state aid formulas will promote a tax system that is fair and affordable for taxpayers while providing the revenue needed for quality public services.

Careful design of relief programs is essential. Untargeted policies can lead to significant erosion of the tax base or require large expenditures. Financing such programs requires increasing other taxes, increasing property tax rates, and/or decreasing local government spending. As a result, overly broad measures can undermine municipal fiscal health and the quality of local services. These are significant impacts, and such untargeted programs still often fail to address the central challenges to the property tax.

Perhaps most important is to avoid policy changes that not only fail to address the problems at hand, but also cause major unintended consequences. Overly restrictive tax limits, for example, have led to declines in the quality of local public services, most notably in educational outcomes, and have diminished local control over budget decisions (Yuan et al. 2009). Tax limits that constrain growth in assessed values are especially damaging, raising fundamental equity issues when owners of similar homes face dramatically different tax bills.

In recent decades, states have implemented hundreds of different property tax relief programs, providing a basis for evaluating the effectiveness of such programs. The rest of this report provides an overview of the common approaches to residential property tax relief—the good, the bad, and the ugly. Effective relief policies can address challenges and build on the strengths of the property tax, increasing its fairness and reinforcing its strength as the linchpin of local government.

A New Jersey state employee confirms data on recently printed property tax rebate checks. *Source: Mel Evans/AP Photo.*

CHAPTER 2

State Policies That Indirectly Affect Property Taxes

State policies heavily influence local property taxes and the efficiency of local governments. *Source: Maryland GovPics/ Flickr CC BY 2.0.*

Local property taxes are heavily influenced by state-level policies, some of which tend to lead to the diminishment of property taxes paid by homeowners without providing direct property tax relief. State actions that can reduce residential property taxes include increasing state aid and improving the formulas by which it is distributed; allowing localities to diversify their revenue structures or adopt classified tax systems; and assuming some local service responsibilities.

State Aid

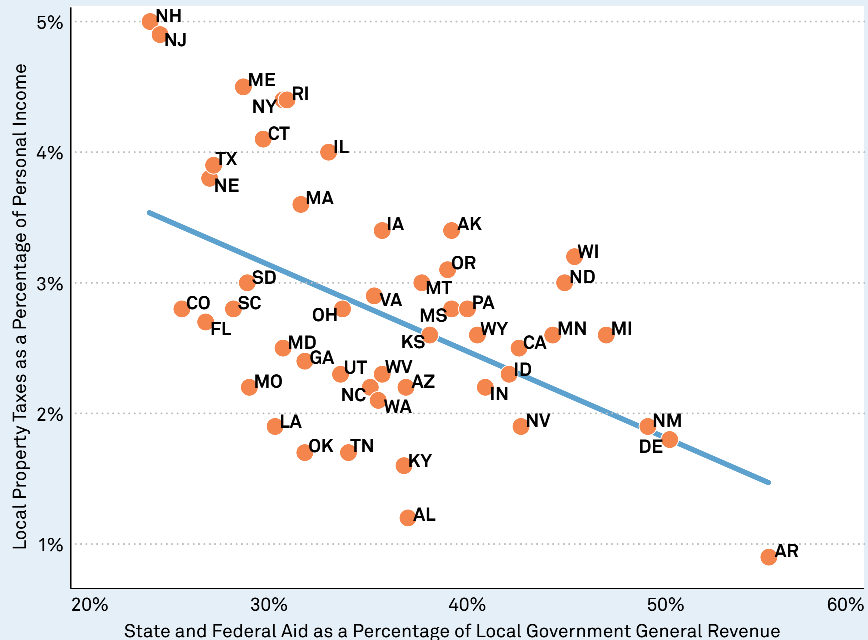
Research shows that increasing state aid leads to reductions in local property taxes, as local governments substitute state aid for local taxes. However, increasing state aid is a very inefficient strategy to provide property tax relief for homeowners, as a large share of state funding will end up increasing local spending or reducing business property taxes instead. Although state aid is critical for reducing fiscal disparities and improving the quality of local services (especially educational outcomes), it is not a substitute for direct property tax relief programs.

Figure 2.1 shows that states providing more aid to local governments generally have lower levels of property taxation. However, state aid is an untargeted way to provide property tax relief. Localities tend to use state grants both to lower their taxes and to increase their spending. This split varies widely, as box 2.1 explains, but a fairly typical split would see a $10 million increase in state aid lead to a $6 million decrease in local taxes and a $4 million increase in local spending. In addition, when state grants allow local governments to reduce property tax rates, the benefit goes to all taxpayers in proportion to the value of their property, including businesses, landlords, and owners of second homes. On average, the $6 million cut in local taxes would be split roughly equally between homeowners and businesses, as nationally around 50 percent of property taxes are paid by businesses (Ernst & Young, Council on State Taxation, and State Tax Research Institute 2019). Thus, in a typical case, policy makers can expect a $10 million increase in state aid to lead to a roughly $3 million drop in

Figure 2.1

The Relationship Between State Aid and Local Property Taxes (2018)

States that rely on state and federal aid for a larger share of local government revenue tend to have lower property taxes.



Note: Hawaii is excluded from the analysis because schools are directly funded by the state government, and Vermont is excluded because school property taxes are primarily collected by the state.

Source: State and Local Government Finance Data Query System 2018.

property taxes for homeowners, with most benefits going to owners of more valuable homes.

Given the indirect way in which state aid affects local property taxes, it is not surprising that extensive research shows that state aid is far more expensive than direct tax relief as a means of achieving the same tax reduction. For example, one study found that it cost three to four times more to provide property tax relief through lump-sum grants to local governments than to do so through a flat dollar property tax credit, which reduces tax bills for all homeowners by a specified dollar amount (Duncombe and Yinger 2001).

That said, state aid is more effective than property tax relief in offsetting fiscal disparities and ensuring that all local governments can fund adequate public services (Duncombe and Yinger 2001). State aid programs should focus on those goals rather than attempt to substitute for direct property tax relief (Kenyon 2007).

It is important to consider which state-level taxes must be increased in order to pay for local aid and state-funded property tax relief. Increasing state income taxes to pay for property tax relief will make the overall tax system more progressive, while increasing sales taxes will make it more regressive. State-level income and sales taxes can be more efficient than decentralized local taxes, but at the cost of reduced local control.

It is possible that increasing state aid and reducing local property taxes could decrease the overall level of education spending in a state, because voters are more willing to tax themselves to support their local schools than to contribute to a general fund that will be redistributed across the state (McGuire 2001). State aid is also a less reliable funding source for education than are local property taxes, as it usually depends on more volatile sales and income taxes and may be cut during economic downturns.

Box 2.1

State Aid Formulas and Property Tax Relief

The extent to which increasing state aid leads to higher local spending rather than lower local taxes depends on a number of factors, including the aid formula, the initial level of local spending, and the fiscal institutions in each state. For most state aid formulas, research indicates that a $1 increase in state aid leads to a rise in local spending in the targeted budget category from $0.20 to $1, with most studies finding an increase in local spending of $0.25 to $0.50. This would leave $0.50 to $0.75 available for tax relief or spending increases in other areas (Fisher 2016). Any tax relief would be split between homeowners and nonresidential taxpayers.

State aid formulas can be grouped into two broad categories:

- **Lump-sum grants**, including what is often called foundation aid for education, calculate the amount of aid based on factors that determine the need for aid but are not directly controlled by local policy. For example, lump-sum grants could consider school districts' property wealth, income, and differences in costs (Chingos and Blagg 2017). Crucially, the level of aid does not depend on local spending decisions.

- **Matching grants** allow local governments to increase their state aid by increasing their spending. District power equalizing grants for education, also known as guaranteed tax base grants, are a form of matching grant, with the level of the match varying based on a school district's per-pupil property tax base. These grants allow each school district to raise the same amount of revenue from any given increase in their local tax rate, so increasing their tax rate increases the amount of state aid.

For any given increase in state aid, matching grants will lead to larger increases in local spending and smaller cuts in local taxes. Most states now use foundation aid formulas for education, and many supplement these with matching grants as well. Many experts feel that lump-sum grants are the best approach for redistribution and for achieving educational adequacy (as long as there are minimum spending requirements for school districts), while matching grants are best for supporting spending on a particular activity, and guaranteed tax base grants are best for promoting equity across school districts (Fisher 2016; Yinger 2004).

Local Revenue Diversification

States can reduce property taxes by allowing local governments to draw on a broader array of local revenue sources. While revenue diversification strengthens local autonomy and fiscal capacity, it can also exacerbate fiscal disparities and does not address voters' concerns about the overall level of taxation.

The share of local revenue from the property tax varies widely across the United States. Figure 2.2 shows that property taxes account for 75 percent or more of locally raised revenue in New England, while accounting for less than 25 percent in Alabama and Arkansas. Not surprisingly, a strong relationship exists between revenue diversification and the level of local property taxes, with lower property taxes often accompanied by higher local sales or income taxes. Allowing these local option taxes is a state decision, with state legislatures generally responsible for authorizing local taxes and setting any maximum rates (Pagano and Hoene 2018).

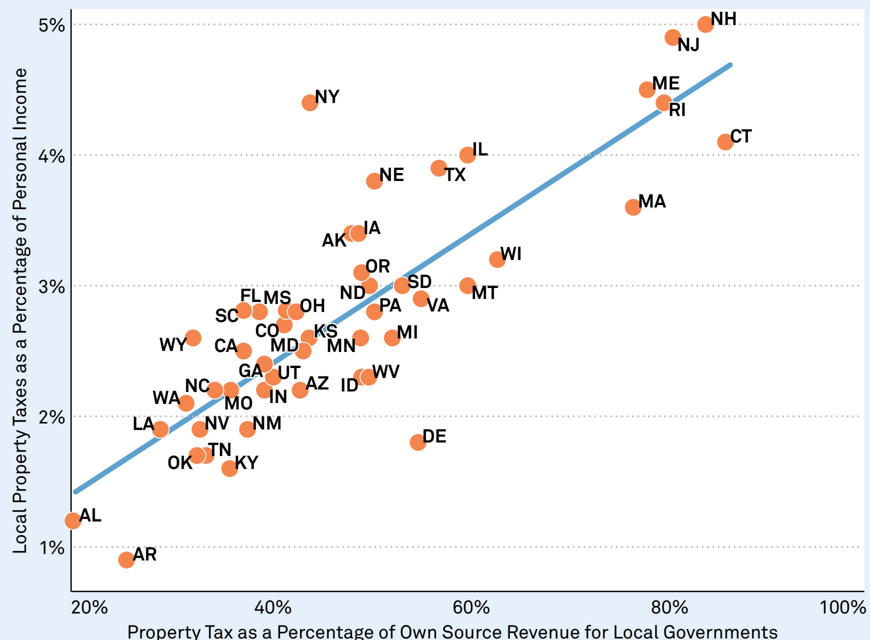
In addition to lowering property tax burdens, local option taxes also increase local governments' fiscal capacity and control over tax and spending decisions. However, research suggests that local option taxes can also increase fiscal disparities, because the same localities that enjoy higher property values often have more robust sales and income tax bases as well (Zhao 2010). Moreover, increasing other taxes to pay for property tax relief will not address concerns among some voters about the overall level of taxation.

Policy makers must weigh the strengths and weaknesses of each revenue instrument (see chapter 1)

Figure 2.2

The Relationship Between Property Tax Reliance and Local Property Taxes (2018)

In states where property taxes account for a larger share of locally raised revenue, property taxes tend to represent a higher percentage of personal income.



Note: Hawaii is excluded from the analysis because schools are directly funded by the state government, and Vermont is excluded because school property taxes are primarily collected by the state.

Source: State and Local Government Finance Data Query System 2018.

Limiting or eliminating school property taxes can lead to lower test scores and other impacts on local education systems. *Source: SDI Productions/Getty Images.*

and consider whether a “tax swap” will be revenue neutral, as described in box 2.2 (page 20). But it is also important to look beyond broad-based taxes toward such alternatives as impact fees, business improvement districts (Sjoquist and Stephenson 2010), special assessments, and betterment contributions (Germán and Bernstein 2018). In addition, states could expand the property tax base by narrowing the range of properties eligible for tax-exempt status, which would allow localities to reduce property tax rates and/or increase property tax collections.

Classification

Classification shifts the property tax burden from homeowners to business taxpayers. While classification is often politically popular, it can distort land use decisions, provide incentives for higher public spending, and reduce economic growth. Homestead exemptions and credits are better alternatives for tax relief.

Classification can significantly reduce property taxes for homeowners, imposing lower effective tax rates on residential property than on business property. Classification decisions are generally a matter of state policy, with a few states allowing classification as a local option. Localities with only one major property type, such as residential suburbs, might choose not to classify even if permitted to do so.

Box 2.2

Tax Swaps in Michigan and South Carolina

A "tax swap" is one way to change a state's revenue mix, with increases in sales or income taxes paying for large property tax cuts. Tax swaps generally increase state-level taxes to fund increased state aid for education, allowing reductions in local school property taxes. In recent years, proposals to fund a near-complete elimination of school property taxes with higher state sales or income taxes have been introduced in Florida, Georgia, Pennsylvania, Texas, and other states (Fisher, Bristle, and Prasad 2010; Ordway 2016).

The record on these tax swaps, however, indicates that they can erode school quality over time. Michigan and South Carolina have undertaken the most dramatic tax swaps. In 1994, Michigan voters approved Proposal A, reducing the average property tax rate for local school districts by 68 percent, placing tight limits on school property taxes, increasing the state sales tax rate from 4 to 6 percent, raising the state cigarette tax, and earmarking a new state property tax and real estate transfer tax for K–12 education (Fisher 2012).

South Carolina passed Act 388 in 2006, eliminating the school property tax on owner-occupied homes (with an exception for taxes to cover debt service), increasing the state sales tax rate from 5 to 6 percent, and implementing new property tax limits, with the overall effect of shifting a large portion of the property tax burden from homeowners to businesses and renters (Kenyon and Paquin 2020).

Table 2.1 shows how these states' rankings in school spending per pupil and test scores have changed since the tax swaps were enacted. Declines in math scores are the most notable change, with Michigan's national ranking for average 8th-grade math scores falling from 15th to 28th, and South Carolina's from 20th to 39th. Changes in reading scores and per pupil spending were more mixed, with declines in Michigan and very modest improvement in South Carolina.

By replacing local revenues with state revenues, tax swaps can mitigate fiscal disparities and at least partially equalize spending across school districts. However, there are also reasons to worry that tax swaps for education funding could hurt school quality.

There are two basic approaches to classification:

- The most common approach uses different **assessment ratios**—the percentage of market value used to determine taxable values—for different classes of property. For example, a state may have a 100 percent assessment ratio for commercial property and a 70 percent ratio for residential property. In this case, a $100,000 commercial property would be taxed on its full market value, while a $100,000 residential property would be taxed as if it were worth $70,000.

- The second approach assigns each property class its own **nominal tax rate**, the rate applied to taxable value to determine the tax bill. The nominal tax rate is also known as the statutory tax rate or millage rate. For example, a city could have a 2.0 percent nominal tax rate for commercial property and a 1.0 percent nominal tax rate for residential property.

If a jurisdiction classifies its property tax, it is better to do this through different nominal tax rates than different assessment ratios. Using a 100 percent assessment ratio for all properties makes it easier for taxpayers to understand their property tax bills and judge the accuracy of their assessments. Fractional assessments are harder to interpret, and may lead taxpayers to mistakenly think that their property is underassessed even if it is actually overassessed.

Classification can be politically popular because it shifts the tax burden from homeowners to businesses. This shift allows for tax exporting, whereby the economic burden of the tax falls on individuals living outside the taxing jurisdiction, including consumers (via higher prices), workers (via lower wages), and business owners and shareholders (via lower profits).

However, there is an economic case that **effective tax rates**—the tax bill as a percentage of a property's market value—should be *lower* on business property

because businesses often use fewer public services than households and may be more responsive to tax differentials. A reasonable middle ground would tax all property uniformly (Bird, Slack, and Tassonyi 2012). Some evidence suggests that classification may deter economic development and reduce growth in commercial property values (Dye, McGuire, and Merriman 2001). Higher taxes on businesses also create pressure for governments to offer tax incentives for businesses to locate in their jurisdiction, which shifts the property tax burden to other residential and business taxpayers (Kenyon, Langley, and Paquin 2012).

Classification can also distort decisions on land use and public spending. Classification lowers the tax price for homeowners (see box 4.2, page 38), so an increase in local spending does not carry a commensurate increase in taxes for residential property. Thus, classification can provide an incentive for higher spending, because it shifts the tax burden from voters (homeowners) to nonvoters (businesses). This tax shift can also result in more land being used for residential purposes and less for nonresidential uses. Classification will also affect land values via capitalization, as the differential tax rates lead to lower business property values and higher residential property values.

In addition, classified tax systems sometimes increase effective tax rates on apartment buildings, although some states treat rental properties the same as owner-occupied homes. If classification increases tax rates on apartment buildings, it will tend to make the property tax system more regressive. That is because tenants generally pay a share of property taxes indirectly through higher rent, and renters have lower incomes than homeowners on average (Bowman et al. 2009; England 2016).

A homestead exemption is a preferable alternative to classification. Both policies shift the property tax burden away from homeowners, but a homestead exemption can also make the property tax distribution more progressive.

Local Government Service Responsibilities

States where local governments are responsible for providing more public services and the state's role is smaller tend to have higher local spending, and therefore higher local property taxes. While there is no optimal split of service responsibilities between state and local governments, it is important to avoid unfunded state mandates.

State policies can affect local property taxes by influencing the level of local spending. One key factor is the way that service responsibilities are divided between state and local governments. For example, community

Table 2.1

School Spending and Test Scores in Tax Swap States

Change in State Ranking Since Passage of Tax Swap

	MI	SC
Tax Swap Passed	1994	2006
School Spending Per Pupil	11 ↓ (11th to 22nd)	4 ↑ (36th to 32nd)
Math (average score for 8th grade)	13 ↓ (15th to 28th)	19 ↓ (20th to 39th)
Reading (average score for 8th grade)	3 ↓ (25th to 28th)	1 ↑ (39th to 38th)

Note: Table reflects change in total current spending from the year before passage to 2019. Test score data were not reported by all states prior to 2003. For Michigan, 2019 test scores are compared to reading scores in 2003 and math scores in 1996 (the earliest years available). In 1996, 11 states did not report math scores; this analysis assumes the 1996–2003 change in those states' math scores matched the change in the national average. For South Carolina, 2005 test scores are used as the baseline (no data available for 2006).

Source: U.S. Department of Commerce 2019b, U.S. Department of Education 2019.

colleges are sometimes funded by the state, and sometimes by localities. Similarly, certain health services may be funded by cities, counties, or state governments. Figure 2.3 shows that local governments shoulder about 60 percent of combined state and local spending in states such as California, New York, and Nebraska, but less than one-third in Delaware and Hawaii. As expected, states where local governments are assigned greater service responsibilities tend to have higher local spending and, in turn, higher local property taxes.

There is no single optimal division of service responsibilities between state and local governments (see table 2.2). A greater state role can reduce fiscal disparities and local tax competition, but it also reduces the ability of local voters to choose the package of taxes and services that best reflects their preferences (Connolly, Brunori, and Bell 2010). However, state policy makers should not impose local service requirements, such as mandating the creation of new programs or training standards for local employees, without providing aid to cover those costs (Primo and Jares 2017).

Local Government Efficiency

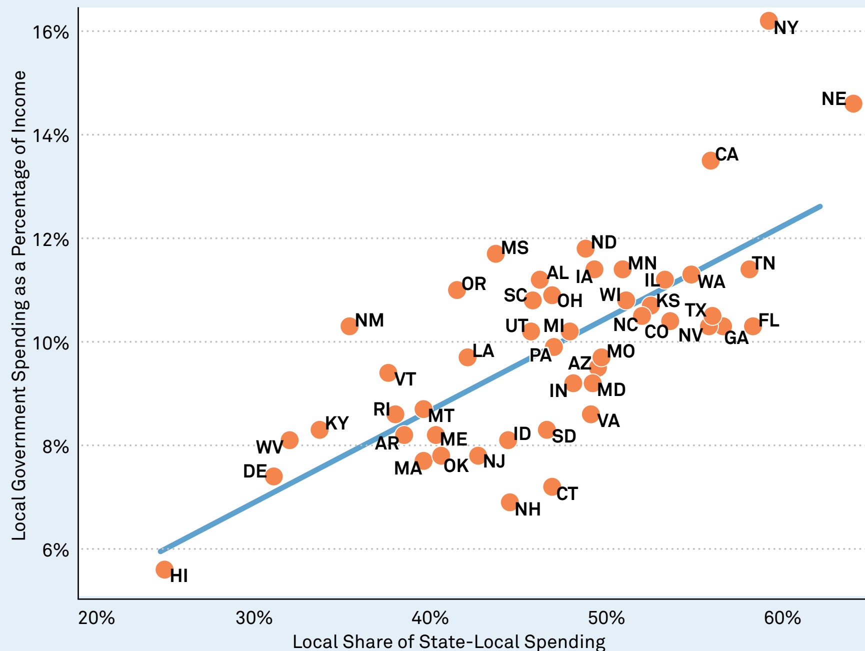
State policies can promote or diminish local government efficiency. Some state aid and property tax relief programs can undermine government efficiency by providing an incentive for higher local spending. Policy makers can avoid this with appropriate program design.

In some cases, high property taxes are primarily driven by high local government spending. Whether this is a problem depends on the reasons for these spending

Figure 2.3

The Relationship Between Local Service Responsibilities and Local Government Spending (2018)

States where local governments are responsible for a larger share of state-local spending tend to have higher local government spending overall.



Note: Alaska and Wyoming are excluded as outliers because their heavy reliance on revenues from the extraction of natural resources allows them to have very high state-local government spending. Data are for direct expenditures.

Source: State and Local Government Finance Data Query System 2018.

Table 2.2

State Actions That Reduce Property Taxes Indirectly

State Action	Benefits	Drawbacks
Increase state aid	Can significantly reduce fiscal disparities among communities and improve the quality of public services and educational outcomes	Far more expensive way to reduce property taxes than state-funded property tax relief programs
Reform state aid formulas to promote equity	Can significantly reduce fiscal disparities and improve the quality of public services and educational outcomes, without requiring an increase in state spending or taxes	Some jurisdictions will receive less state aid unless reform is paired with an overall increase in state aid and/or temporary hold-harmless provisions, which would block any cuts
Reform state aid formulas to promote efficiency	Lump-sum grants can provide aid while ensuring that taxpayers bear the costs and benefits of higher local taxes and services on the margin	Sometimes providing an incentive for higher local spending, as is done with matching grants, is desirable
Allow local governments to increase other taxes or fees	Increases local governments' fiscal capacity and local control over fiscal decisions	Can exacerbate fiscal disparities among communities; other local revenue sources often have drawbacks compared to property taxes
Adopt classified tax system statewide, or allow localities to classify	Reduces property taxes for homeowners without cutting revenues by shifting tax burden to businesses, vacation homes, and sometimes rental properties and, indirectly, renters	Can harm economic development and reduce local government efficiency
Take responsibility for providing more services	Reduces fiscal disparities and local tax competition	Reduces local control over fiscal decisions

decisions. It is appropriate for jurisdictions to spend more if they have higher expenditure needs, costs of services, or spending preferences. Cities with larger numbers of school-age children, for instance, will need to spend more on K–12 education, and cities with higher crime will need to spend more on police and fire protection. Similarly, cities facing higher costs of living and higher prevailing wages will need to offer higher salaries to attract qualified workers. State aid formulas should take these differences into account by adjusting for socioeconomic factors that influence expenditure needs and for differences in the costs of providing public services (Chingos and Blagg 2017).

In some cases, jurisdictions impose higher taxes because their residents prefer a higher level of spending and are willing to tax themselves to pay for that spending. These preferences do not indicate a need for more state aid and are one reason why policy makers should take care to avoid tax or expenditure limits that prevent voters from choosing their preferred level of taxing and spending (see chapter 3).

High spending is a problem if it reflects inefficient operations, with localities spending more than necessary to provide public services that more efficient jurisdictions can deliver at lower cost. Shared service agreements and government consolidation are often recommended as means of improving efficiency (Kodrzycki 2013; Marlowe 2018). State policy makers must pay careful attention to the local tax price, which can have significant efficiency implications (see box 4.2, page 38). Both state aid and property tax relief programs can reduce the local tax price considerably, which can provide an incentive for higher local spending, but it is possible to design programs that do not distort the tax price. In a similar way, classification systems that reduce residential tax payments at the expense of business properties will reduce homeowners' tax price and encourage higher spending.

CHAPTER 3

Tax Limitations

Protesters in Newbury, Massachusetts, express their positions on a proposed property tax override. Local governments can sometimes exceed state tax limits with voter approval. *Source: Cheryl Senter/The Boston Globe.*

Tax limitations are one of the most common responses to political pressure for property tax relief. These limits can constrain growth in property taxes, but they may also shift the revenue mix to less reliable sources, reduce the quality of local services, and impede local governments' ability to respond to local preferences and changing circumstances. To avoid politically unacceptable tax increases without resorting to inflexible tax limitations, it is critical that local officials reduce tax rates during periods of rapid growth in property values.

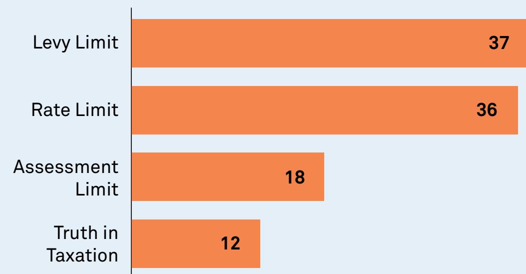
Research shows that most property tax revolts are a response to dramatic increases in property taxes, particularly when these result from rising home values (Fisher, Bristle, and Prasad 2010). These political reactions have led to some form of state-level property tax limitations in most jurisdictions (see figure 3.1).

However, tax increases deemed unacceptable by the public are not an inherent feature of the property tax that requires across-the-board limits. Instead, they are typically caused by administrative and political shortcomings in the tax system. The main problems are long delays in revaluation and failure to reduce tax rates when values rise precipitously. The best protections are well-functioning assessment and rate-setting procedures, such as the Truth in Taxation measures discussed in this chapter.

To understand the effects of tax limitations, it is important to begin with a clear understanding of the operation of property tax systems before imposition of any limitations.

Figure 3.1

Number of States with Tax Limits (2019)



Source: Significant Features of the Property Tax 2019.

Property Tax Bills in a Budget-Driven System

Absent any limitation measures, a value-based property tax begins with the assessor's computation of the total taxable value in the jurisdiction as of the annual assessment date. This value, adjusted to reflect exemptions and other exclusions, provides the local governing body with the year's property tax base.

In a **budget-driven system,** the property tax can act as a "residual" fund to support that part of the budget not covered by other taxes, user charges, intergovernmental grants, and other sources. The governing body would then set the tax rate at the level required to raise the necessary revenue, sometimes called the "levy." A substantial increase in property values will lead to a reduced tax rate if spending remains constant. Accurate valuations do not determine the tax revenue to be raised; they determine the distribution of the total tax levy across the jurisdiction.

In contrast, a **rate-driven system** begins with a given tax rate and automatically applies that to annual taxable value. Such a system justifies taxpayer fears that increases in assessed values will automatically translate into higher tax bills, which can cause political leaders to delay revaluations in order to avoid opposition from property owners.

Table 3.1 (page 26) provides a simplified example to illustrate the importance of considering the entire system by which tax bills are calculated. The assessor determines taxable value, but it is the governing body's choice of a tax rate that sets the amount taxpayers owe. If property values are growing rapidly, it is critical that elected officials reduce tax rates to avoid sharp increases in tax bills. Some taxpayers mistakenly assume that rising values directly lead to higher tax bills, which can create political opposition to necessary revaluations, even though responsive rate setting can largely address these concerns. This example also shows that different points in the tax-setting process may be the subject of limitations. Some tax limits place a ceiling on the tax rate, while others restrict growth in assessed values, and still others focus on growth in overall property tax revenues.

Rate Limits

Rate limits typically set a cap on property tax rates for specific local governments, although some states cap the overall property tax rate or freeze local tax rates as of a given date. Rate limits in themselves would not necessarily restrict growth in tax revenues if the restricted rates were applied to a growing tax base. Rate limits suffer from a one-size-fits-all approach, because the same rate that might raise more than enough revenue in areas with high property values could be insufficient to support essential services in low-value jurisdictions.

Ceilings on tax rates are the simplest and oldest form of tax limitation. Rate limits typically set a cap on property tax rates for specific local governments, such as counties, municipalities, or school districts. For example, the tax rate for Arkansas municipalities cannot exceed 0.5 percent. In some states, the limit applies to the overall property tax rate. In California, basic property tax bills cannot exceed 1 percent of assessed value (Paquin 2015). Other limits freeze local rates as of a given date.

While rate limits may constrain the ability of local governments to adjust tax rates in response to changed circumstances, they do not prevent taxes from rising with growth in property values. In fact, they can encourage more frequent revaluations to reflect growth in the tax base—although this will cause revenue to fall when property values decline.

Rate limits suffer from the inflexibility common to all measures intended to constrain the property tax. They do impose fiscal restraint, but the same rate that raises more than enough revenue in one jurisdiction can be inadequate for the service needs of another. This means that rate limits have a much greater impact on poorer jurisdictions whose low property values may not be able to generate sufficient revenues at rates that might be more than adequate for wealthier areas (see box 3.1). In either case, if assessed values fall, previous rates might not be sufficient to maintain services.

Table 3.1

Property Taxes in Two Cities with Rising Property Values

If property values grow 10 percent per year and a city does not adjust its tax rate, then property tax bills will be 46 percent higher after four years (City A). But rising property values will not lead to higher property tax bills if tax rates are adjusted down (City B).

City A: Keeps Tax Rate Fixed, so Tax Levy Grows

Year	Tax Base	Tax Rate	Tax Levy	Home Value	Tax Bill
0	500,000,000	1.00%	5,000,000	100,000	1,000
1	550,000,000	1.00%	5,500,000	110,000	1,100
2	605,000,000	1.00%	6,050,000	121,000	1,210
3	665,500,000	1.00%	6,655,000	133,100	1,331
4	732,050,000	1.00%	7,320,500	146,410	1,464

City B: Decreases Tax Rate Each Year, so Tax Levy Is Flat

Year	Tax Base	Tax Rate	Tax Levy	Home Value	Tax Bill
0	500,000,000	1.00%	5,000,000	100,000	1,000
1	550,000,000	0.91%	5,000,000	110,000	1,000
2	605,000,000	0.83%	5,000,000	121,000	1,000
3	665,500,000	0.75%	5,000,000	133,100	1,000
4	732,050,000	0.68%	5,000,000	146,410	1,000

Note: Assumes property values increase 10 percent per year.

Rate limits should be targeted to a specific level of government and calibrated to its spending needs. Oregon and Indiana have taken a different approach, setting a limit on the combined tax rate of overlying governments. This can create a perverse incentive for subdistricts, such as school and library districts and special authorities, to set their rates at the maximum level. Otherwise, their unused tax capacity could be taken by other subdistricts, leaving no margin for future growth (Ross, Farrell, and Yang 2015).

Assessment Limits

Assessment limits set a cap on annual growth in the assessed value of individual properties. They prevent sharp tax increases due to rising property values, but their significant unintended consequences make them the most problematic form of property tax limitation. Assessment limits shift the tax burden toward poorer neighborhoods, create large disparities in tax bills for owners of similar properties, lead to "lock-in" effects that discourage mobility, and introduce new complexities into the property tax system.

The most well-known assessment limit is California's Proposition 13, which caps annual growth in assessed values at the lesser of 2 percent or the rate of inflation. Voters approved Proposition 13 in 1978 after house prices in California rose 80 percent from 1975 to 1978 (Fisher, Bristle, and Prasad 2010). Its success at the voting booth illustrates the popular appeal of assessment limits that are expected to prevent rising values from leading to sharp property tax increases, particularly for residents whose incomes are not increasing at an equivalent rate.

Box 3.1

Proposition 2½ in Massachusetts

The two major elements of Proposition 2½, a Massachusetts statute enacted in 1980, are straightforward: a 2½ percent levy limit and a 2½ percent rate limit. But the interaction of these two provisions can burden struggling communities in unpredictable ways that do not affect prosperous jurisdictions. The levy limit allows property tax revenue to grow by only 2½ percent a year, but it is adjusted for new construction and can be increased by a public vote. The rate limit restricts collections to 2½ percent of the taxable value of property. In cities with strong economic growth, new construction allows property tax revenues to grow considerably more than 2½ percent per year. In those places, real estate values have increased faster than property tax levies, reducing the effective tax rate and insulating the jurisdiction from the rate limit.

In low-growth communities, the opposite effect can increase the effective tax rate. To maintain stable revenue, the tax rate must rise when property values decline. Tax rates will also need to rise if values are stagnant but the cost of government services rises. This can cause the rate limit to become a binding constraint, so allowable annual increases in property tax revenues are far less than 2½ percent. For example, the western Massachusetts city of Pittsfield was unable to increase its property tax revenues by 2½ percent per year between 2016 and 2020, because its rate was capped at 2½ percent of taxable value and values were decreasing. In 2017, the city's property tax revenues could grow by only 0.51 percent. In the city of Springfield, the rate limit similarly restricted collections for fiscal years 2011 to 2016, with allowable revenue actually falling in 2012 and 2013.

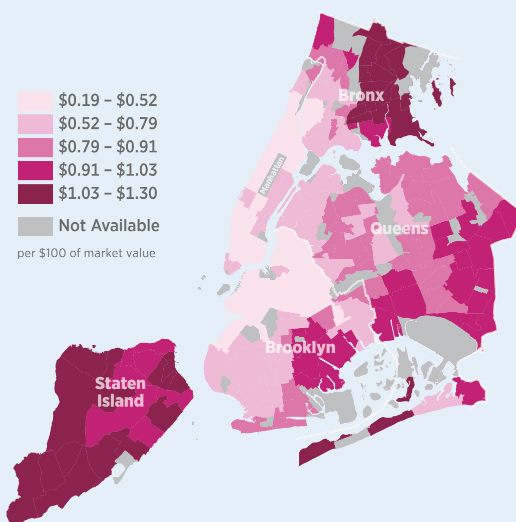
Statewide property tax limits enacted in Massachusetts in 1980 have affected low-growth communities such as Pittsfield more than wealthy communities. *Source: DenisTangneyJr/iStock/Getty Images Plus.*

But assessment limits achieve this goal in a very inequitable way. Targeted tax relief and responsive rate setting are better alternatives. In fact, taxes can still rise under assessment limits if rates are not similarly constrained.

Assessment limits act mainly to shift the tax burden. If tax rates rise to maintain revenue, even homeowners whose assessed value is reduced because of the limit may pay more in taxes than they would without the cap. As a result, owners of low-value residences experiencing modest price increases often subsidize taxpayers whose property is more valuable and appreciating more rapidly (Dye and McMillen 2007).

Figure 3.2

Median Effective Tax Rate by Neighborhood for Residential Properties with 1–3 Units (2017)



New York City's assessment limit has shifted the tax burden toward lower-income neighborhoods with slower housing price appreciation, resulting in far higher effective tax rates in much of the Bronx and Staten Island than in Manhattan and wealthier sections of Brooklyn.

Source: Regional Plan Association 2018.

The subsidy to properties with the most dramatic appreciation, often located in the wealthiest areas, is illustrated by the experience of New York City. Taxable values of one-, two-, and three-family houses there may rise by no more than 6 percent per year or 20 percent over five years. Rapidly appreciating areas have grown in value far beyond these limits, while less affluent neighborhoods bear heavier tax burdens as a result, as shown in figure 3.2. An analysis by the New York City Independent Budget Office (2018) found that if all properties were taxed at the same rate in a revenue-neutral manner, 71 percent would pay less than under the current system. This analysis shows that tax shifts under New York City's assessment limit have created far more losers than winners, but this has occurred through a system that is completely opaque to most taxpayers. The lack of transparency for those who are paying more, and the dramatic subsidies accruing to those who benefit from the caps, present political challenges to eliminating or even adjusting these provisions in the future.

Tight assessment limits also produce wide disparities in the tax bills faced by owners of similar homes in the same neighborhood. Long-time homeowners, who may have purchased property when it was more affordable and who may no longer be burdened by mortgage debt, are subsidized by those who bought their homes more recently. A study by the Lincoln Institute of Land Policy and the Minnesota Center for Fiscal Excellence (2021) examined a number of jurisdictions subject to assessment limits, comparing the 2020 taxes on a newly purchased median-value home with those on a home of equivalent value held for the average tenure in the city. Figure 3.3 shows that the newly purchased home had a tax bill more than 40 percent higher than the bill for a home held for the average duration in New York City, Miami, and many cities in California.

Assessment limits can produce a "lock-in" effect that inhibits mobility when owners are discouraged from moving because they seek to preserve their below-market assessment (Ferreira 2010).

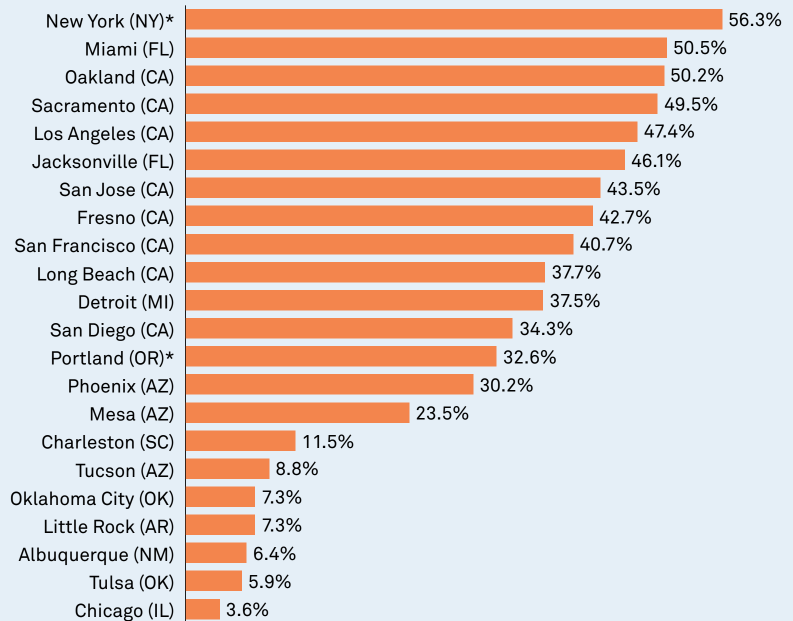
Figure 3.3

Impact of Assessment Limits (2020)

This figure illustrates the difference in property taxes between a newly purchased home and a home that has been owned for the average duration for each city (for median-valued home).

** New York City and Portland (OR) have unique assessment limits, because they do not reset when a property is sold, as occurs in other cities. For these cities, figure 3.3 shows the difference in property taxes on a newly built home and a home built prior to the implementation of assessment limits (1981 in New York City; 1996 in Portland).*

Source: Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence 2021.



A disincentive of this type can reduce the supply of starter homes and drive up their prices (Walczak 2018).

The lock-in effect and other unintended consequences of assessment limits can lead to additional measures meant to mitigate those impacts, which further complicate a state's property tax system and lead to new unintended consequences of their own. For example, after Florida's "Save Our Homes" assessment limit left residents feeling locked in their homes, the state enacted legislation allowing "portability" of a portion of the tax savings to a new residence. In this case, the assessment of the new home is not based on its market value or on the acquisition price, but rather reflects tax savings accumulated on a prior residence. Yet the new owner arrives with undiminished service needs and expectations. Similarly, after approving Proposition 13 in 1978, California voters later passed measures allowing children and grandchildren to inherit the limited assessments under Proposition 13. There was no requirement that the heirs live in the property until a 2020 ballot measure added this provision; at the same time, that measure increased assessment "portability" for seniors and for taxpayers with disabilities. These expansions of assessment limits magnify tax disparities even further and undermine the clarity, transparency, and accountability that are key strengths of a value-based tax.

Levy Limits

Levy limits restrict growth in overall property tax revenues collected in a specific jurisdiction. They are preferable to rate limits and especially to assessment limits because they constrain taxes with fewer unintended consequences. However, tight levy limits restrict the ability of local governments to respond to local challenges and changed conditions and can have severe effects on local budgets if they are not designed carefully.

Unlike rate and assessment limits, levy limits directly cap tax collections, and so can have severe consequences for local governments if the limit is set at too low a level, as the example in box 3.2 (page 30) illustrates. They reduce local governments' ability to

A poll worker wipes down voting booths in Madison, Wisconsin, in November 2020. In a year marked by concerns about the pandemic and unemployment, Wisconsin voters passed 95 referenda approving school district tax revenue increases. *Source: Wisconsin State Journal.*

Box 3.2

Wisconsin's Strict Levy Limit and the Importance of Voter Overrides

Wisconsin has one of the most restrictive levy limits in the country. Since 2011, the state has allowed no growth in municipal and county property tax revenues except for increases reflecting the value of new construction. Because this allowance is based on new construction, it varies widely across the state. Since the state implemented the levy limit, some jurisdictions with extensive new construction have been allowed levy increases above 20 percent, and many others without new construction have faced a levy limit of zero. In 2013, the levy limit was further tightened by requiring local governments to reduce their property tax revenue by the amount raised from any new fees for specific services such as garbage collection or snow removal, if those services had previously been funded by the property tax. While the state's levy limit is very strict, local governments can exceed the limit with voter approval through a referendum.

The state legislature also determines the annual permitted rise in school district taxes, and districts seeking tax revenue above this amount must obtain voter approval in a referendum. Of the more than 400 school districts in the state, 280 have passed at least one referendum approving revenue increases since 2016. In 2019, 34 school districts held referenda, with an 85 percent approval rate. In 2020, Wisconsin voters approved 95 school referenda, an extraordinary indication of support in a year marked by the pandemic, increased unemployment, and a large-scale shift to virtual schooling (Wisconsin Policy Forum 2020).

respond to local needs and conditions and can erode public services. For example, New York State adopted a levy limit in 2012 restricting increases in local property tax revenue in much of the state to the lesser of the rate of inflation or 2 percent. A period of low inflation left municipalities with permissible increases under 2 percent for the fiscal years 2014 through 2018, and under 1 percent in 2016 and 2017. Overriding this limit requires a 60 percent supermajority in a local referendum. Even as the national economy recovered from the 2007–2009 recession, budgets for counties subject to the levy limit in New York State fell, with double-digit declines in spending for health and community services (Lav and Leachman 2018).

Levy limits usually exempt property taxes on new construction. This is an important provision, because new development requires additional services, and revenue raised from new construction is not a burden on existing taxpayers. Levy limits should also make allowance for revenue increases from population growth even when not accompanied by new construction.

"Banking" any unneeded revenue allowed under a levy limit is also recommended. It avoids perverse incentives for governments to tax to the maximum extent possible if otherwise they risk losing needed growth in future years. For example, two experts concluded that Utah's levy limit, "which was intended to limit property tax increases to less than 6 percent, actually drove increases, because the nuances of the law provided an incentive to increase the tax by the full 6 percent" (Cornia and Walters 2005, 622).

Levy limits do not constrain taxes for individual properties or affect the distribution of the tax across properties. This maintains an equitable apportionment of the tax according to value, unlike assessment limits, which can produce widely differing taxes on nearly identical properties. However, it also means that other measures, such as circuit breakers or deferrals (see chapter 4), should be considered if individual taxpayers face particularly large tax increases.

Common Features of Tax Limits

The effects of tax limits vary greatly depending on their design. Some have severe impacts on local budgets, while others exert reasonable constraint while still leaving flexibility to respond to changing conditions. Some of the most important features of tax limitations are discussed below.

GROWTH RATE

The impact of a tax limit depends greatly on the permitted level of growth. States utilize a variety of approaches, including fixed rates (e.g., 4 percent annual growth), the inflation rate, the lesser of a fixed rate and the rate of inflation, and the rate of growth in personal income. Setting a fixed rate presents the daunting challenge of estimating future spending needs and cost increases. Given the impossibility of an exact prediction and the damages risked by a rate that is too low, it is better to err on the side of a higher cap. A cap that is too low will magnify all the negative unintended consequences discussed in this chapter. A high cap will have minimal impact in most years but will prevent particularly large tax increases.

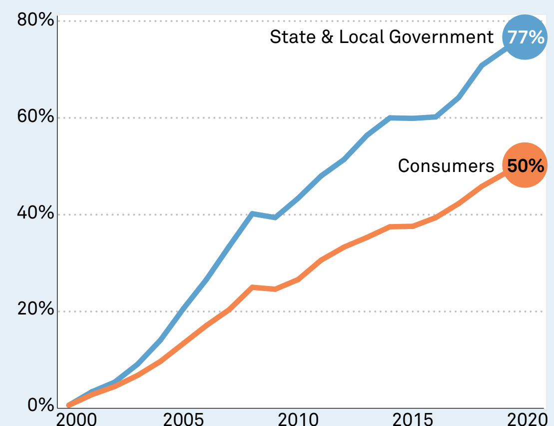
In setting the growth rate, the best approach is to link the limit to growth in personal income, which will allow modest improvements in public services over time without increasing the tax burden relative to earnings. Alternatively, limits can be tied to the implicit price deflator for state and local government, which is an index that reflects increases in the cost of goods and services purchased by state and local governments. This will allow "cost of living" adjustments to maintain current service levels. As figure 3.4 shows, the cost of a typical bundle of goods and services purchased by state and local governments has risen significantly faster than the average cost of consumer purchases.

GOVERNMENTS AFFECTED BY LIMIT

Some property tax limitations affect all local governments, while others apply only to select entities, such as school districts, counties, or municipalities. Because all limits suffer from the inflexibility of a one-size-fits-all approach, policy makers should consider targeting specific limits to each level of government. These limits could vary according to spending needs, access to alternative revenues, and other individual characteristics.

Figure 3.4

Inflation for Consumers and for State and Local Government (2000–2020)



Tax limits tied to the consumer price index (CPI) have reduced the real level of local government services, because the prices of goods and services purchased by local governments have grown faster than the CPI.

Source: U.S. Department of Commerce 2021, U.S. Department of Labor 2021.

Research indicates that assessment limits in U.S. cities including Miami produce disparities in the tax bills faced by owners of similar homes in the same neighborhood. *Source: juanngomezz/pixabay.*

OVERRIDES

Many state-imposed limits allow localities to exceed the cap by voter approval in a local referendum. In some states, a supermajority is required for passage. The override option preserves a local voice on budget decisions and permits some flexibility to respond to local conditions. An override option does not negate the constraining effect of the limitation. Overrides are serious undertakings, often involving multiple community meetings and outreach to allow voters to gauge the effect of an increase on taxes and services (Adams 2019). Overrides should require only a simple majority, to reflect local preferences and avoid minority veto power.

DEBT EXCLUSIONS

Rate and levy limits often exclude taxes raised to pay debt service on voter-approved borrowing. This is recommended as a means of protecting bondholders and bond ratings, and so reducing borrowing costs. The exclusion can be terminated when the debt is fully repaid.

Effects of Tax Limits

While there are very important differences among types of tax limits, most research on their effects has studied them as a group, identifying several common consequences of all types of tax limits. Given the drawbacks discussed below, states should consider the Truth in Taxation measures described in box 3.3 as an alternative.

CHANGING REVENUE MIX

The primary effect of many property tax limits is to change the revenue mix for local governments, although very restrictive tax limits have greater effects on spending levels. Frequently, reduced reliance on property taxes is offset by greater reliance on user charges and state aid (Yuan et al. 2009).

Many experts express concern that these alternative revenue sources will not compensate for the forgone property tax revenue in the long run. Because local user charges are feasible only for certain activities, there is a natural limit on the revenue that can be raised in this way. Charges are generally earmarked to fund specific services, such as trash collection and water, which restricts local governments' ability to use them to replace funding for other programs (Yuan et al. 2009). State-imposed tax limits are often paired with additional aid for local governments, particularly for school districts. However, state aid can be an unreliable revenue source. Many states reduce local aid during recessions, when assistance may be most needed. In Massachusetts, inflation-adjusted

Table 3.2

Tax Limits Summary

Good	Truth in Taxation
Bad	Levy Limits
Worse	Rate Limits
Worst	Assessment Limits

non-education aid to localities fell by 44 percent between the fiscal years 2001 and 2015 (Lav and Leachman 2018).

DECLINE IN LOCAL SERVICE QUALITY

There is evidence that more restrictive tax limits can erode the quality of public services. Many studies have investigated the impact of tax limits on school quality, generally finding them to be associated with lower school spending and reduced test scores (Downes and Figlio 2018). Tax limits affect other services as well. As noted, the strict levy limit in New York State has been associated with greatly reduced spending on health and community services (Lav and Leachman 2018).

REDUCED FLEXIBILITY AND LOCAL CONTROL

All state-imposed tax limits reduce local control over budget decisions and so diminish the capacity of local governments to respond to taxpayer preferences and changing circumstances. A single statewide limit for very different jurisdictions may have no effect in wealthier areas or high-growth regions while severely constraining struggling or declining communities. The ability to override a limit by popular vote is an important means of preserving a local voice in fiscal self-representation. As mentioned, requiring a majority vote for an override, rather than a supermajority, avoids providing veto power to a minority of the electorate.

Box 3.3

Truth in Taxation—An Alternative to Tax Limits

Truth in Taxation measures, also called Full Disclosure, generally require any increase in property tax revenues due to value increases to follow the same procedures as are required for an increase in the tax rate. This may involve advertisements, public hearings, and mailed individual notices identifying the impact on individual tax bills.

These laws are designed to avoid “silent” tax increases that occur when rising values produce higher tax bills without any change in the official tax rate. Truth in Taxation restrains growth in property taxes during periods of rising home values by encouraging more responsive rate setting, but avoids the unintended consequences associated with other types of tax limits (see table 3.2).

Although the public engagement required by Truth in Taxation measures is not in itself a tax limitation, it can be a significant hurdle for local governments. For example, Tennessee does not allow property tax revenues to rise automatically when property values increase. After a general reappraisal, counties and municipalities must provide public notice and hold open hearings before adopting a tax rate that would generate more revenues than in the year before the reappraisal, even if the tax rate itself hasn’t changed. Nashville chose not to initiate this process after a 2017 reappraisal and instead reduced its tax rate by 30 percent to keep collections level—a dramatic step that led to controversy when city leaders sought to raise tax rates by approximately one-third in 2020 (Loricchio 2020).

Research indicates that Truth in Taxation can reduce growth in property taxes in areas of rising home values without imposing a single binding tax limit on all local governments (Cornia and Walters 2006). These laws promote voter engagement in debate on the appropriate level for property tax rates and help elected officials gauge the electorate’s views on tax burdens and service needs. The resulting publicity, accountability, and transparency can themselves serve to discourage marginal additional spending that might otherwise follow a “silent” tax increase.

CHAPTER 4

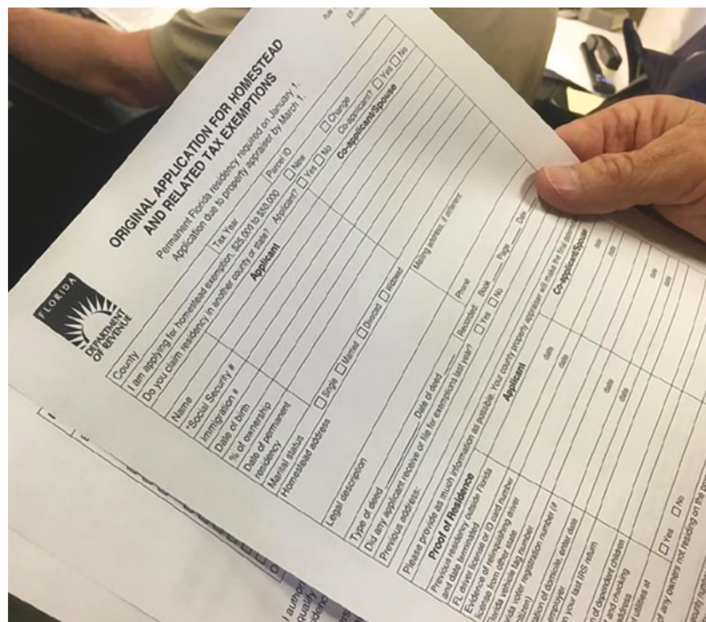
Property Tax Relief Programs

Exemptions, credits, and other targeted tax relief policies can help homeowners and increase the fairness of the property tax. *Source: AzmanL/Getty Images.*

Targeted and effective relief programs are the best response to concerns over high property taxes. Circuit breakers, deferrals, and homestead credits each address specific property tax challenges without undermining the strengths of this essential revenue source. Relief programs can make the property tax more progressive, offset rapid tax increases, assist taxpayers who are housing-rich but income-poor, and help households with the least ability to pay.

Homestead Exemptions and Credits

Homestead exemptions and credits can make the distribution of the property tax more progressive. These broad-based exemptions and credits are usually available for all owner-occupied primary residences, although some states restrict eligibility to seniors or provide seniors with additional benefits. Businesses, renters, and owners of second homes are almost never eligible for homestead relief and, as a result, bear a larger share of the tax burden, particularly if the state government does not extend aid to offset the reduction in local revenue due to homestead relief.



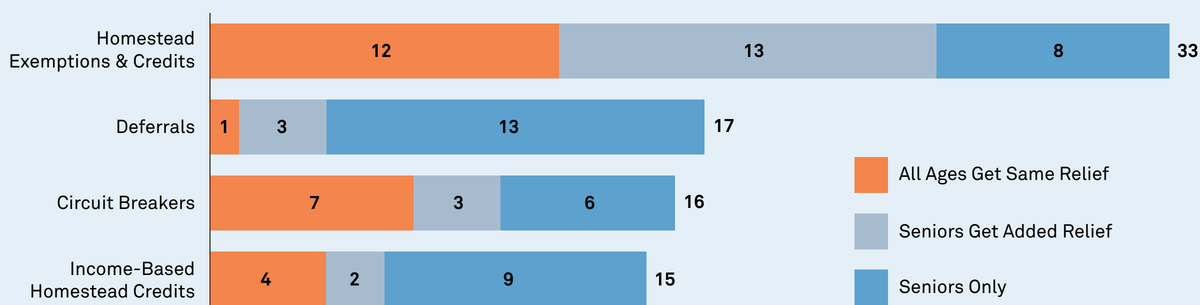
Homestead exemption application from the Florida Department of Revenue. *Source: Courtesy photo.*

Homestead exemptions and credits are the most common type of property tax relief (see figure 4.1). These programs provide either a partial exemption from the tax or a partial credit against the property tax bill, with either of these being a fixed dollar amount or a specified percentage. Although there are many similarities among these approaches, there are also important differences in their effects.

Table 4.1 (page 37) compares the tax relief under a flat $20,000 exemption and a 10 percent exemption, given a 1 percent tax rate. A $20,000 exemption reduces the taxable value of a $100,000 home to $80,000, and with a 1 percent rate will lower the tax bill from $1,000 to $800. A 10 percent exemption on a $100,000 house will lead to a taxable value of $90,000 and a tax bill of $900.

Figure 4.1

Number of States with Property Tax Relief Programs (2018)



Note: Figure reflects programs that cover all homeowners, all seniors, or all low-income seniors; it excludes narrower programs for veterans or homeowners with disabilities. The count is for statewide programs; it excludes local option programs. Some sources consider income-based homestead credits to be a type of circuit breaker rather than a separate category of property tax relief. Under that definition, there would be 30 states with circuit breaker programs—11 states where all ages get the same relief, 5 where seniors get added relief, and 14 for seniors only.

Boston provides a generous homestead exemption. *Source: alexeys/iStock Editorial/Getty Images Plus.*

Box 4.1

Boston's Residential Exemption

Boston has one of the most generous homestead exemptions in the country, with the city exempting the first $295,503 of value from taxation in 2021. Homeowners need to apply once to prove they own the property and live in it as their primary residence, but then receive the exemption automatically in future years. Fifteen other cities and towns in Massachusetts have also adopted residential exemptions under the state's local option program. Boston's exemption has several notable features:

- The exemption is equal to 35 percent of the average assessed value for all residential properties in the city ($844,295 in 2021), which includes one- to three-family homes, condominiums, and apartment buildings. Thus, the amount of the exemption automatically adjusts for changes in home values over time. Other Massachusetts municipalities have set their exemption equal to anywhere from 10 to 35 percent of the average assessed value for residential properties in their communities (Gilbert and Rassias 2019).

- The exemption cannot exceed 90 percent of any home's assessed value, which ensures that no homeowner has a tax price less than 0.10, as explained in box 4.2 (page 38).

- The city's property class system prevents the homestead exemption from shifting the tax burden to businesses, while creating a more progressive tax distribution among homeowners. This is done by first allocating the tax levy across the city's four property classes based on their full value without any homestead exemptions. The residential tax rate is then calculated on the basis of net residential value (i.e., total value minus the residential exemption).

The key difference is that the flat dollar exemption produces a more progressive distribution of tax, while a percentage exemption does not affect this distribution. For example, box 4.1 shows how Boston's residential exemption makes that city's property tax system more progressive. Flat dollar exemptions are progressive because they exempt a larger percentage of the assessment on low-value homes, which generally are owned by lower-income households. In this example, a $20,000 exemption reduces property taxes by 20 percent on a $100,000 home, 10 percent on a $200,000 home, and 5 percent on a $400,000 home. By contrast, a 10 percent property tax exemption will produce a 10 percent tax reduction for all three houses. Percentage exemptions provide the largest dollar reduction in taxes to owners of homes of the highest value. In this example, taxes would fall by $100 on the $100,000 home and by $400 on the $400,000 home.

Homestead credits reduce tax bills directly, rather than reducing taxable values. As in the case of exemptions, flat dollar credits are more progressive than percentage credits.

One advantage of flat dollar credits is that they provide property tax relief without changing the homeowner's marginal tax price, thereby avoiding an incentive for higher tax and spending levels (see box 4.2, page 38). In contrast, the other three approaches can all provide incentives for higher spending.

Programs that provide property tax relief to all homeowners are less cost-effective than targeted measures. However, policy makers sometimes seek to offer at least some relief to all homeowners, in which case, flat dollar homestead credits and exemptions are the best option. The progressivity introduced by these programs can also help correct regressivity due to the difficulty of accurately assessing low-value property, whether because of thin markets, a lack of information on interior conditions, or a paucity of conventional sales and mortgages.

Table 4.1

Property Tax Cuts Under Homestead Exemptions and Credits

(With 1.0% Tax Rate)

Flat dollar exemptions and credits make the property tax distribution more progressive, providing larger relative tax savings for lower-income homeowners, whereas percentage exemptions and credits do not.

	$100,000 Home	$200,000 Home	$400,000 Home
Tax before exemptions or credits	1,000	2,000	4,000
Flat Dollar Exemption (Ex: $20,000)			
Taxable value after exemption	80,000	180,000	380,000
Tax bill after exemption	800	1,800	3,800
$ Savings	200	200	200
% Savings	**20%**	**10%**	**5%**
Percentage Exemption (Ex: 10%)			
Taxable value after exemption	90,000	180,000	360,000
Tax bill after exemption	900	1,800	3,600
$ Savings	100	200	400
% Savings	**10%**	**10%**	**10%**
Flat Dollar Credit (Ex: $200)			
Tax bill after credit	800	1,800	3,800
$ Savings	200	200	200
% Savings	**20%**	**10%**	**5%**

Note: Percentage credit is not shown because it has the same effects as a percentage exemption.

Table 4.2

Tax Price: The Impact of Homestead Exemptions and Credits on an Increase in the Property Tax Rate

(Tax Rate Increases from 1.0% to 1.1%)

Only flat dollar credits provide property tax relief without distorting the tax price and providing an incentive for higher local government spending.

	$100,000 Home	$200,000 Home	$400,000 Home
Tax bill with no exemptions or credits	1,100	2,200	4,400
$ Increase compared to 1.0% rate	100	200	400
Tax Price	**1.00**	**1.00**	**1.00**
Tax bill after $20,000 exemption	880	1,980	4,180
$ Increase compared to 1.0% rate	80	180	380
Tax Price	**0.80**	**0.90**	**0.95**
Tax bill after 10% exemption	990	1,980	3,960
$ Increase compared to 1.0% rate	90	180	360
Tax Price	**0.90**	**0.90**	**0.90**
Tax bill after $200 credit	900	2,000	4,200
$ Increase compared to 1.0% rate	100	200	400
Tax Price	**1.00**	**1.00**	**1.00**

Income-Based Homestead Credits

Income-based homestead credits tie the amount of property tax relief to applicants' incomes, with credits decreasing as income increases. These means-tested programs provide more targeted and cost-effective relief than homestead exemptions or credits that do not take income into account. However, means testing can also reduce participation rates and increase administrative burdens.

States use two different approaches for income-based credits. The most common measures are income-based **percentage credits**, sometimes known as "sliding-scale circuit breakers" (Bowman et al. 2009). These programs define several income brackets, and taxpayers within each bracket receive the same percentage reduction in property taxes. For example, a state might provide a 75 percent property tax credit for households with incomes up to $10,000, a 50 percent credit for incomes of $10,001–$20,000, and a 25 percent credit for incomes of $20,001–$30,000.

Box 4.2

Tax Prices and Incentives for Higher Spending

One important strength of the local property tax is transparency. Voters usually have a good understanding of the connections between local taxes and spending, which should encourage tax and spending decisions that reflect the preferences of the typical voter. However, efficient decisions require that local voters bear the full cost of higher local taxes and spending *at the margin*. Even if targeted relief were to eliminate most of a homeowner's tax obligation, having responsibility for the last dollar of taxes will provide an incentive to homeowners to weigh the benefits and drawbacks of that additional spending. The **tax price** is the ratio of the marginal percentage increase in taxes that a voter pays to a marginal percentage increase in local spending. For example, if local spending increases 3 percent and a voter's taxes also increase 3 percent, the tax price is 1.0.

Many property tax relief programs and state aid programs reduce the local tax price below 1.0, which means that local voters do not bear the full marginal cost of higher spending. This can create incentives for inefficiency, as local governments increase taxes and spending above optimal levels. However, it is often possible to design relief programs and state aid formulas that do not reduce the local tax price or reduce efficiency.

Table 4.2 (page 37) shows the different effects on tax price of three homestead exemption and credit programs. Without property tax relief, a 10 percent increase in the tax rate would increase the tax bill of the owner of a $100,000 home by $100, from $1,000 to $1,100. With a flat dollar credit, the homeowner would still bear the full cost of the tax increase at the margin, with the tax bill increasing by $100, from $800 to $900. By contrast, the owner would face only 80 percent of that increase (an $80 rise in taxes) under a $20,000 exemption, and only 90 percent (a $90 rise in taxes) under a 10 percent exemption. State aid through matching grants and district power equalizing grants reduces the local tax price below 1.0, while lump-sum grants and foundation aid formulas do not (see box 2.1, page 17).

Programs that improve the progressivity of the property tax can allow governments to raise needed funds with less impact on lower-income residents. It is important, however, to avoid unintentional incentives for increased spending. Extensive evidence indicates that both state aid and property tax relief programs can lead to higher local taxes and spending (Duncombe and Yinger 2001), especially when these programs reduce the local tax price. While higher local spending can leave residents better off and is often the intended outcome of state aid programs, it works against the intended goal of property tax relief programs, as the higher local taxes offset some of the direct property tax relief.

In areas that are less built up or that don't limit new construction, lower property taxes can lead to increases in new housing as people choose to live in places with a more appealing package of taxes and services (see box 4.3, page 40). *Source: Bryan Siders/ Flickr CC BY-NC-ND 2.0.*

The second approach is to use income-based **dollar credits**, sometimes known as "quasi circuit breakers" (Bowman et al. 2009). States also define several income brackets for these programs, with each taxpayer within that bracket receiving the same *dollar* reduction in property taxes. For example, a state could provide a $750 property tax credit for households with incomes up to $10,000, a $500 credit for incomes of $10,001–$20,000, and a $250 credit for incomes of $20,001–$30,000.

The number of income brackets for these programs varies widely. While the most common structure uses four to seven brackets, some states employ far more, such as the 36 income brackets used under Idaho's Property Tax Reduction Program (Lincoln Institute of Land Policy 2019b). More brackets reduce problems with "notch effects," where a small increase in income can lead to a large drop in property tax relief as a taxpayer moves from one bracket to the next. In the prior example for an income-based dollar credit, a $1 increase in income could lead to a $250 decrease in property tax relief. It is possible to eliminate notch effects entirely by using a formula for either an income-based percentage or dollar credit, such as the approach used for Colorado's Property Tax Rebate program.

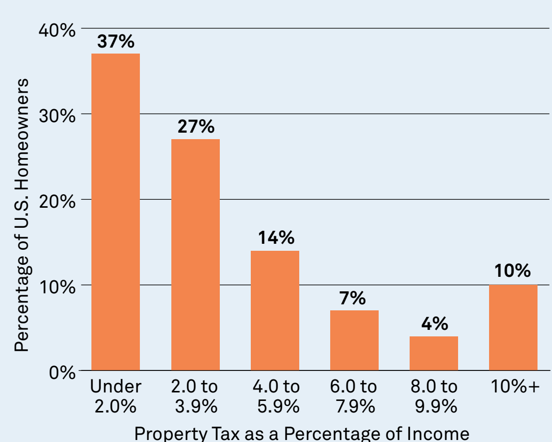
Percentage credits are more likely to provide adequate relief for homeowners with the highest property tax burdens, as the amount of property tax relief increases with homeowners' property tax bills at any given income level. However, **dollar credits** do not change homeowners' marginal tax price and thus avoid encouraging higher spending and taxes, as can occur with percentage credits. Given these trade-offs, neither approach is clearly better than the other.

Circuit Breakers

Circuit breakers target property tax relief to homeowners paying the highest share of their income in property taxes, such as seniors on fixed incomes, low-income homeowners in gentrifying neighborhoods, and individuals facing a sudden reduction in earnings. These programs are more cost-effective than those that provide a small amount of tax relief to all homeowners, because they can allow significant assistance to the most heavily burdened households at a lower cost overall.

Figure 4.2

Property Tax as a Percentage of Income (2019)



Circuit breakers target relief to households spending the highest share of their income on property taxes, such as the 21 percent of homeowners spending 6 percent or more of their income on property taxes.

Source: U.S. Department of Commerce 2019c.

Property tax circuit breakers are meant to prevent homeowners from being overburdened by property taxes, just as an electrical circuit breaker prevents electric current overloads. They offer relief when property taxes exceed a threshold percentage of income (see figure 4.2, page 39). For example, under a 5 percent threshold circuit breaker, taxpayers would receive a credit equal to the amount by which their property tax bill exceeds 5 percent of their income. A household with $10,000 in income and a tax bill of $700 (7 percent of $10,000) would receive a $200 tax credit.

States have added many features to this basic formula in an effort to reduce program costs and/or direct greater relief to low-income households. Most states impose income ceilings to restrict eligibility and benefit limits to constrain the amount of relief provided to any taxpayer. It is important to avoid income ceilings and benefit limits that are too low, to ensure that homeowners receive adequate relief (Bowman et al. 2009). For example, in 2018, circuit breaker benefits were capped at $200 in Oklahoma and $250 in New Mexico. This does not provide sufficient relief for heavily burdened households. Neither state has increased its limit for at least a decade. Benefit limits vary widely; in 2018, a quarter of states set a benefit limit lower than $400, while half of states set a benefit limit of $1,000 to $1,500, and a quarter imposed a limit above $2,500 (Lincoln Institute of Land Policy 2019b).

Two better ways to control program costs and to focus relief on low-income households are to use multiple-threshold circuit breakers and a co-payment requirement. A multiple-threshold formula is more progressive and provides greater relief to households with the least ability to pay property taxes. These programs set multiple threshold percentages that increase from the lowest income bracket to the highest, with thresholds applied incrementally as in the case of a graduated income tax. For example, a circuit breaker could offer a credit to offset property tax above 2 percent of income for the first $10,000 in income, above

Box 4.3

Tax Capitalization

It is important to consider the effect of tax relief programs on home values. A vast body of research has found that local taxes and services influence the market value of residences. This process of capitalization raises property values in jurisdictions with better packages of taxes and services and lowers them in communities with higher taxes and/or worse public services.

Assuming public services are constant, the extent to which taxes are capitalized into property values depends on the responsiveness of the housing supply to increased demand. In built-up areas with geographic or regulatory restrictions on new construction, as in much of the West Coast and the Northeast, lower property taxes will be capitalized into higher property values. In areas that are less built up or do not limit new construction, lower property taxes will lead to increases in new housing construction as people choose to live in areas with a more appealing package of taxes and services (Hanson 2019; Hilber 2017; Lutz 2015). In this way, tax relief programs may increase home values, particularly in areas with restricted housing supply. An adjustment to reflect the present value of property tax relief in future years may occur quite quickly. Table 4.3 illustrates the way in which lower taxes can increase the price a prospective purchaser can offer for a given residence.

An unintended consequence of tax relief could therefore be a windfall gain to current owners whose house prices rise as a result, while the benefit to future purchasers could be diminished by the increased cost of housing. To diminish concerns about capitalization, it would help to more narrowly target tax relief to those who most need it, as with circuit breakers, and consider setting a minimum number of years that people must own their home before qualifying for relief. Deferrals are the best way to avoid capitalization of tax relief.

Residential neighborhoods in Albuquerque, New Mexico (top), and Edmond, Oklahoma (bottom). In both states, circuit breaker benefits are too low to provide adequate tax relief. *Sources: aceshot1/Shutterstock (top), Bill Wilson/Flickr CC BY 2.0 (bottom).*

4 percent of income for the next $20,000 in income, and above 6 percent for income from $30,001 to $60,000. In 2018, ten states used multiple-threshold formulas, and six states used a single threshold (Lincoln Institute of Land Policy 2019b). Six of these 16 states use co-payment requirements, which help control program costs and reduce incentives for higher local spending. For example, Michigan has a 40 percent co-payment that requires most taxpayers to contribute 40 percent of property taxes above the threshold percentage, with the circuit breaker offsetting the remaining 60 percent (see box 4.4, page 42). Without co-payments, eligible taxpayers would have a tax price of zero and be completely shielded from any property tax above the threshold. As a result, they would have no incentive to scrutinize or moderate local spending increases. Even with co-payments, circuit breakers usually reduce recipients' tax prices more than broadly available exemptions and credits, but because they are targeted to a narrow set of households, circuit breakers are still less likely to encourage higher local spending.

Deferrals

Property tax deferral programs allow homeowners to delay payment of their property taxes until ownership of the home is transferred. At that point, the full amount of deferred tax becomes due, typically with interest. Deferrals directly address liquidity concerns faced by homeowners who are housing-rich but income-poor, allowing them to draw on their home equity to pay current property tax bills. Unlike other forms of tax relief, deferrals impose no long-term cost on other taxpayers. Yet they can also provide very substantial assistance—usually allowing homeowners to defer 100 percent of their tax liability.

Table 4.3

Property Tax Relief Capitalized into Higher Home Values

In this example, a 20 percent homestead credit allows a homeowner to afford a $220,000 home on the same monthly budget as a $210,000 home without property tax relief.

	No Tax Relief	With Tax Relief
Home Value	210,000	220,000
Monthly Housing Costs	1,000	1,000
Mortgage	800	840
Property Tax	200	160
20% Tax Credit	0	40

Note: 30-year fixed-rate mortgage (4% interest rate) with 20% down payment. To simplify the example, numbers are rounded slightly and the pre-credit tax liability is held constant.

Box 4.4

Michigan's Homestead Property Tax Credit

Michigan has one of the better circuit breakers in the country. The Homestead Property Tax Credit is a refundable state income tax credit available to all households with incomes less than $60,000. For most taxpayers, the credit offsets 60 percent of property taxes above 3.2 percent of household income, up to a maximum of $1,500. For example, consider a homeowner with a $40,000 income and a $2,000 property tax bill. The tax bill exceeds the 3.2 percent threshold by $720 ($2,000 vs. $1,280), resulting in a credit worth $432 (60 percent of $720). The 40 percent co-payment is reduced for seniors (65+) with incomes under $30,000, and completely eliminated for taxpayers with disabilities and seniors with incomes under $21,000. The credit is phased out for households with incomes above $51,000 by reducing the credit by 10 percent for each $1,000 above $51,000. Renters are eligible, with 23 percent of rent considered as property taxes for the purposes of calculating the credit. Homeowners are ineligible if the market value of their home exceeds $270,000. In 2019, more than 1.1 million taxpayers claimed the Homestead Property Tax Credit, realizing an average tax savings of $669 (Michigan Department of Treasury 2021).

Eligibility for deferrals is usually restricted to low-income seniors. Deferrals are an excellent solution for these households, as most seniors own their homes and have considerable home equity. In addition, most seniors prefer to age in place (AARP 2018), and deferrals ensure that no eligible homeowner will be forced to move due to property taxes (see table 4.4).

Most programs exclude homeowners with reverse mortgages and set a minimum level of home equity to qualify for deferral. States commonly require equity equivalent to 15 to 25 percent of home value, although some states set the minimum at a far higher level (Lincoln Institute of Land Policy 2019c). These requirements increase the likelihood that governments are fully repaid when the home is sold and the lien for deferred taxes is redeemed. However, they also mean that other types of relief may be needed for taxpayers without significant home equity, such as a young homeowner who has lost a job.

The interest due on deferred taxes should be modest and vary with market rates (Munnell et al. 2017). Charging too high an interest rate means that government would be making money from the population it is trying to assist, mainly low-income seniors. Policy makers should also consider lowering the minimum age for participation in deferral programs. In some states, homeowners in their forties and fifties pay a higher share of income in property taxes than older homeowners (California Legislative Analyst's Office 2018), and they may have considerable equity in their residences. A lower age limit could be one instrument to help protect long-time homeowners in gentrifying neighborhoods.

The biggest weakness of most deferral programs is their very low participation rates. Part of the reason for

Downtown Holland, Michigan. The state offers a circuit breaker credit to all households with incomes less than $60,000, with additional benefits available for low-income seniors. *Source: Stania Kasula/Alamy Stock Photo.*

Shoveling snow in Crested Butte, Colorado. Tax deferral opportunities in the Centennial State include programs for seniors and active-duty service members. *Source: John Terence Turner/ Alamy Stock Photo.*

low participation is that many seniors are reluctant to place a lien on a home that they hope to leave to their heirs. However, awareness of deferral programs is also very low. Governments can increase participation with better outreach and advertising, by simplifying application procedures, and by offering low interest rates (see box 4.5). Especially in the first few years, greatly expanded participation could require state and local governments to take cash management steps such as borrowing from a revolving debt account each year to cover the gap between taxes deferred and taxes repaid on homes that have sold (Munnell et al. 2017).

Key Features for Relief Programs

Three factors are key to the success of any property tax relief program: the funding mechanism, the eligibility criteria, and the method of administration.

STATE VS. LOCAL FUNDING

One key difference among relief programs is whether they are funded by states or localities. State governments cover the cost of almost all income-based homestead credits and circuit breakers, and more than half of deferral programs, but only about

Table 4.4

Summary of Property Tax Relief Programs

Good	Homestead Exemptions and Credits (Flat Dollar Only)
Better	Income-Based Homestead Exemptions and Credits
Best	Circuit Breakers Deferrals

Box 4.5

Colorado's Property Tax Deferral for Seniors

Colorado's Property Tax Deferral for Seniors has many elements of a well-designed deferral program. While the program is restricted to homeowners 65 or older, it imposes no income ceiling. To qualify, the total value of all mortgages and liens cannot exceed 75 percent of the property's market value, and the total value of deferred taxes, interest, and any liens cannot exceed 100 percent of market value. Colorado also allows military personnel to defer property taxes due while they are on active service, with a reduced home equity requirement. Under state law, the interest rate on deferred taxes is equal to that on the latest 10-year Treasury note, with the 2021 interest rate set at just 1.081 percent. Taxpayers must submit an annual application to their county treasurer's office, which is then sent to the state treasurer's office to determine eligibility. The state makes payments to each county on behalf of taxpayers who have deferred their taxes.

Participation in this statewide program is considerably higher in Boulder County than elsewhere, which shows the importance of outreach. To raise awareness of the deferral program and other relief options, the Boulder County treasurer and assessor give annual presentations to seniors and distribute informational brochures about the programs. The county had 343 households enrolled in 2019 and a participation rate of approximately 1.6 percent (U.S. Department of Commerce 2019d; Weissman 2021).

one-third of broad-based homestead exemptions and credits (Lincoln Institute of Land Policy 2019a–c). States provide funding through either direct payments to taxpayers or transfers to local governments to offset the revenue lost because of these programs. Where local governments bear the cost, they must compensate by raising property tax rates, increasing other taxes or fees, or reducing spending. Thus, without state funding, relief programs may not reduce the property tax burden overall but rather shift it toward taxpayers who are not eligible for relief, often businesses, renters, and owners of second homes.

While there are fundamental differences among the four basic types of relief programs, they often employ similar eligibility criteria. These criteria determine whether taxpayers who need property tax relief can actually receive it.

State funding is preferable because it mitigates disparities in property wealth across localities, as poorer jurisdictions often lack the resources to provide relief themselves. State funding helps to ensure that all taxpayers who need relief can receive it, no matter where they live. If a state is unwilling to fund a relief program, it is better to offer it as a local option than as a statewide mandate, to preserve each locality's ability to respond to its individual fiscal situation. Even states that do not fund these programs may be able to provide valuable administrative assistance.

ELIGIBILITY CRITERIA

While there are fundamental differences among the four basic types of relief programs, they often employ similar eligibility criteria (see table 4.5). These criteria determine whether taxpayers who need property tax relief can actually receive it. They also have critical implications for program costs, administrative complexity, and participation rates.

Age Requirements

Many property tax relief programs are limited to homeowners who are at least 65 years old. While seniors often pay a larger portion of their income in property taxes than younger homeowners, housing costs as a share of income are roughly the same for both groups, because seniors are less likely to have mortgage obligations. Seniors also have greater net worth and lower rates of poverty (Bowman et al. 2009). This means that age is a flawed proxy for whether a household needs property tax relief.

Limiting eligibility to seniors is particularly problematic in the case of income-based homestead credits and circuit breakers. These two types of programs calculate relief based on income and property tax bills—much better measures of property tax burdens than age. However, restricting eligibility to seniors can be more appropriate for homestead exemptions and credits without income limits, as it dramatically reduces program costs without the administrative burdens of imposing an income ceiling. Limitation of deferral programs to seniors reflects the likelihood that this group may be house-rich, with considerable home equity, but relatively income-poor.

Homeownership Requirement

While property tax relief programs are designed primarily for homeowners, it is crucial to consider the treatment of renters in the design of such programs. Even though renters do not receive property tax bills, they pay a share of property taxes indirectly when

Table 4.5

Recommendations for Eligibility Criteria

Recommended	✓ Cover All Ages ✓ Cover Renters ✓ Maximum Property Value
Consider	• Income Ceiling • Residency Requirements
Avoid	× Net Worth Limit

Many property tax relief programs are limited to homeowners who are at least 65 years old, but age is a flawed proxy for whether a household needs property tax relief. *Source: fotografixx/ iStock.*

these costs are passed on by their landlords in the form of higher rents (Bowman et al. 2009; England 2016). In addition, the median household income for renters is roughly half that of homeowners (U.S. Department of Commerce 2019e).

Broad-based homestead exemptions and credits almost never cover renters, but renters are included in nearly half of income-based homestead credit programs and almost all circuit breakers. Benefits are delivered to renters through rebate checks or income tax credits. Homestead exemptions and credits are often paired with a separate credit for renters. Circuit breakers for renters generally set a percentage of rent, often 20 percent, assumed to represent property taxes (Lincoln Institute of Land Policy 2019b).

Income Ceilings

Many programs use income ceilings to restrict eligibility to taxpayers whose income falls below a given level. In this way, a larger share of tax relief is directed to lower-income taxpayers, and program costs are reduced. However, most programs with income ceilings also require an annual application, which increases administrative costs and can significantly reduce participation rates. In addition, local governments rarely have income data for their taxpayers, so income ceilings often require a state role in program administration—either running the program themselves or sharing data with local governments. Income ceilings that are too low deny relief to moderate-income households with heavy property tax burdens. Setting the ceiling around the state median household income is a reasonable middle ground that constrains program costs without excluding moderate-income households. Figure 4.3 (page 46) shows that income ceilings are usually lower than median incomes, with most limits falling between $20,000 and $60,000. Legislation creating property tax relief programs should require annual inflation adjustments for income ceilings, benefit limits, and other dollar figures that are used to determine eligibility and calculate benefits; otherwise, property tax relief will become increasingly inadequate over time.

Relief programs designed to assist low-income homeowners can help balance the difficulties of accurately assessing low-value properties.

Net Worth Limits

A small number of programs also set limits on household net worth. This makes sense in theory, to avoid using scarce resources to lower the tax burden on owners with significant wealth but limited cash income. However, net worth tests greatly increase administrative complexity, particularly if nonliquid assets are included, and may discourage participation because of more burdensome application requirements and privacy concerns (Bowman et al. 2009).

Maximum Property Value

Setting a maximum property value is a type of asset test, but less complex and intrusive than a more comprehensive net worth limit. It avoids providing property tax relief for high-value homes but does not present any new administrative challenges because it is based on the existing property assessment. Because a single statewide limit could exclude a large share of homeowners in areas with higher housing prices, programs in some states vary the limit by county, such as Nebraska's Homestead Exemption program.

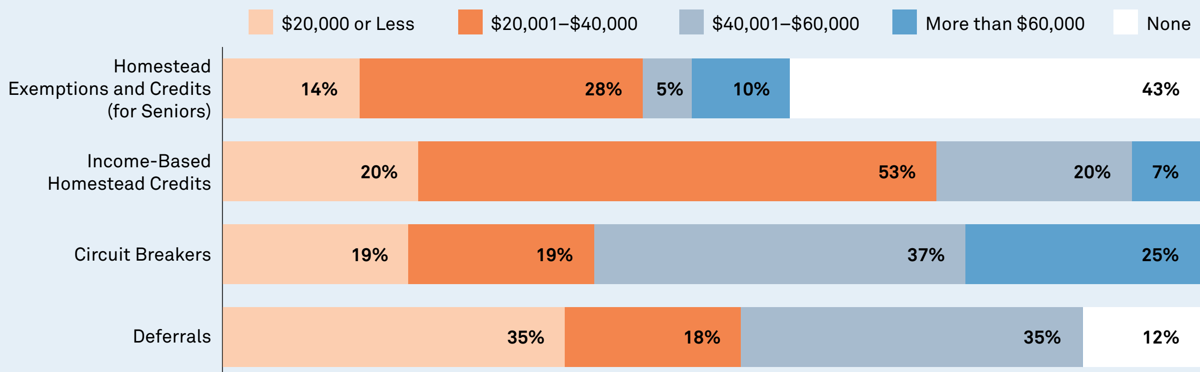
Residency Requirements

Some programs are limited to taxpayers who have owned their homes for a minimum number of years. For example, South Dakota's property tax deferral requires that taxpayers have owned their home for three years or lived in the state for five years. These requirements lower the risk that by reducing homeowners' taxes immediately, relief programs will encourage taxpayers to buy more expensive homes than they can afford. These provisions also decrease program costs and direct benefits to long-time homeowners, such as seniors and low-income homeowners in gentrifying areas. However, they would exclude recent purchasers dealing with job loss or other financial setbacks.

Figure 4.3

Income Ceilings for Property Tax Relief Programs (2018)

Percentage of Programs with Income Ceilings in Various Ranges



Low income ceilings control costs but exclude moderate-income households.

Note: For programs where income ceilings vary by age, tenure, or the number of people in the household, the figure shows the ceiling for married homeowners who are seniors.

Source: Lincoln Institute of Land Policy 2019a–c.

ADMINISTRATION, PARTICIPATION, AND OUTREACH

Effective administration and outreach are essential to the design of successful programs. In particular, application procedures and methods of benefit delivery have a crucial impact on participation rates.

The approach used to deliver benefits to taxpayers determines whether relief is timely and addresses voters' desire for property tax relief. The best approach uses a property tax exemption or credit to deliver benefits to homeowners (Bowman et al. 2009).

- **Rebate check:** Some programs deliver benefits by sending taxpayers a rebate check. This approach can be a good option for renters and for states without an income tax.
- **Income tax credit:** This approach has the lowest administrative costs and paperwork burdens, as there is no need to create a separate property tax relief program. However, there can be a long delay between payment of a property tax bill and receipt of relief through an income tax refund. In addition, this approach may not satisfy political pressure for property tax relief, as it may be perceived as income tax relief instead.
- **Property tax exemption or credit:** This approach reduces property tax bills directly, eliminating the need to wait for relief through a separate process and satisfying voters seeking easily identifiable property tax relief. Broad-based homestead exemptions and credits without income ceilings can usually be administered as property tax exemptions or credits without a state role. However, programs that need some method of income verification, such as circuit breakers, usually require state–local coordination to deliver benefits.

A neighborhood in Sioux Falls, South Dakota. The state's property tax deferral requires three years of homeownership or five years of in-state residency. *Source: Lost_in_the_Midwest/ Shutterstock.com.*

Table 4.6

The Trade-Off Between Cost-Effectiveness, Participation Rates, and Administrative Complexity

	Cost-Effectiveness	Participation Rates	Administration & Compliance
Homestead Exemptions and Credits	Low	High (≈90%)	Simple
Income-Based Homestead Credits	Moderate	Low (≈40%)	Moderate
Circuit Breakers	High	Low (≈40%)	Moderate
Deferrals	Very High	Very Low (under 1%)	Complex

The most cost-effective relief programs often suffer from low participation rates, but governments can boost participation with outreach, advertising, and a simple application process.

Note: Estimates for participation rates from Baer 1998.

A trade-off often exists between cost-effectiveness, participation rates, and administrative complexity. As shown in table 4.6, broad-based homestead exemptions and credits generally have very high participation rates and simple administration. However, providing a small amount of relief to all homeowners can prove very expensive while still leaving some households with unaffordable tax bills. Conversely, income-based homestead credits and circuit breakers are more cost-effective, but they often suffer from low participation rates, with many eligible households failing to apply for relief. Deferrals are very cost-effective. If the full amount deferred is eventually collected and if the interest charged covers administrative expenses and the municipality's costs of borrowing funds in the interim, they impose no long-term costs on other taxpayers. However, they are the most difficult to administer and typically have very low participation rates.

Effective program design and outreach can boost participation, but some trade-offs are unavoidable. The eligibility criteria and benefit formulas that allow programs to be cost-effective also require taxpayer information and government verification. A key factor is whether the program requires an annual application, or whether enrollment carries over automatically into future years.

Outreach and advertising are critical to boosting awareness of relief programs, and nonprofit organizations can also help increase awareness among eligible homeowners.

Annual application is usually required for programs with income limits on eligibility, such as circuit breakers, deferrals, income-based homestead credits, and most homestead exemptions and credits for senior citizens. However, not all programs with income ceilings require annual application (Lincoln Institute of Land Policy 2019a–c). Continued enrollment after a household has qualified once in a base year can increase participation and reduce administrative costs, but requires verification to reduce fraud. Even relief programs that do not have income ceilings may require verification to ensure that, for example, nonresident taxpayers do not claim homestead exemptions on second homes (see box 4.6).

Typical participation rates are around 90 percent for homestead exemptions and credits, 40 percent for income-based homestead credits and circuit breakers, and 1 percent for deferrals. However, participation rates vary significantly across states (Baer 1998).

Participation will increase with effective outreach and advertising and simplified application procedures. Outreach and advertising are critical to boosting awareness of relief programs, and nonprofit organizations can also help increase awareness among eligible homeowners. Application procedures should be user-friendly, with a sufficiently long application period and online access. Governments should avoid requiring documentation for information they can easily obtain; in some cases, taxpayers could automatically qualify for relief with effective data sharing between state and local governments.

In Harris County, Texas, which includes Houston, officials regularly audit homestead exemptions to reduce fraudulent claims. *Source: Silvio Ligutti/Shutterstock.com.*

Box 4.6

Auditing Homestead Exemptions

One way to increase the cost-effectiveness of tax relief programs is to reduce the number of fraudulent claims, which is particularly important for programs that do not require taxpayers to apply annually. Audits, whether conducted internally or by external consultants, can draw on such data sources as voter registration lists, driver's licenses, death records, and court decrees to help confirm homestead status.

In Florida, audits are important because the state's large number of seasonal residents do not qualify for the "Save Our Homes" assessment limitation. In 2017, Sarasota County undertook the state's first homestead audit, identifying 547 erroneous exemptions among the county's 110,000 homestead properties. This recovered $6.7 million in back taxes and added $75.6 million in taxable value to the county's rolls (Murdock 2017).

In Texas, a number of counties have undertaken homestead audits, finding many mistaken exemptions due to common errors such as unreported deaths, multiple residences, and younger generations occupying family homes that still carry senior-citizen preferential assessments. An external audit of Harris County identified 7,000 accounts requiring revision out of a total of 850,000 reviewed. The county sends annual "confirmation cards" to homestead addresses, and checks returned cards against driver's licenses, land records, and voting registries (Nikaj 2013).

CHAPTER 5

Administrative Reform

Regular revaluation is one important component of fair, efficient property tax systems. *Source: SLRadcliffe/iStock/Getty Images Plus.*

Administrative reforms can improve the fairness and efficiency of property tax systems. They can help ensure assessment accuracy, avoid sharp year-to-year tax increases, and create more taxpayer-friendly billing systems. Modern valuation techniques, regular revaluation cycles, and effective appeals systems that allow taxpayers to identify mistakes and lodge objections can all enhance assessment accuracy. Adjusting tax rates in times of rising property values is crucial to stabilizing tax bills. Phasing in unusually large assessment increases and allowing monthly property tax payments can reduce pressure on household budgets.

Quality Assessment Practices with Regular Revaluations

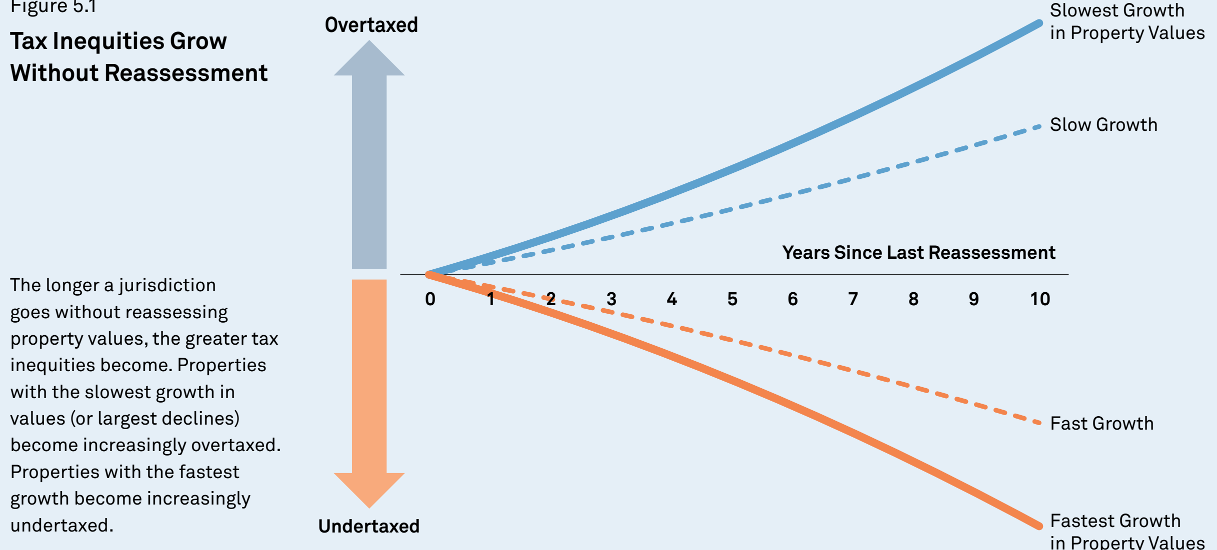
Accurate assessments are essential for equity under a market-value property tax system. Without accurate valuation, the distribution of property taxes will be unfair and arbitrary. Assessment accuracy depends on regular revaluations, and is enhanced by modern valuation techniques, state oversight of local assessing offices, and effective appeals systems. Regular revaluations should be paired with tax rate reductions during periods of rising values. New assessments after long-delayed revaluation may need to be phased in to moderate sharp changes in tax liabilities.

The most common cause of inaccurate assessments is that too much time has passed since the last revaluation. Figure 5.1 shows how tax inequities grow as assessments become increasingly outdated. When old assessments are carried over without adjustment, homes in areas with the fastest growth in property values are undertaxed, subsidized by overtaxation of homes in declining neighborhoods. For example, when Nassau County on Long Island went for decades without reassessment, the disparities in tax burdens between affluent and struggling communities caused disproportionate taxation of homeowners of color. This ultimately resulted in a 2003 reassessment under a consent decree with the U.S. Department of Justice. Failure to revalue had not prevented tax appeals, but rather encouraged them, leaving the county with $100 million to $150 million in annual refund costs (Dornfest 2010).

The cost of revaluation depends on many factors, including the type and homogeneity of property in the jurisdiction, the quality of existing data, and the ability to use in-house staff. A 2010 review found that the annual assessment budget for the Williamson Central Appraisal District in Texas, which used in-house staff for regular reappraisals and statistical updates, totaled 0.6 percent of collections, while Idaho jurisdictions spent approximately 1.4 percent of revenue on a combination of in-house experts and outside contractors (Dornfest 2010). Normal revaluation expenses are easily justified. They can be considerably less than

Figure 5.1

Tax Inequities Grow Without Reassessment



The longer a jurisdiction goes without reassessing property values, the greater tax inequities become. Properties with the slowest growth in values (or largest declines) become increasingly overtaxed. Properties with the fastest growth become increasingly undertaxed.

the distortion in tax obligations caused by inaccurate assessments, and delaying a revaluation undermines trust in the assessment system and the market-value basis for the tax (Dornfest 2010).

Most states set a maximum number of years that can elapse between reassessments (see figure 5.2). In interim years, some jurisdictions do not alter these values, but a better strategy uses statistical approaches to make annual adjustments. The *Standard on Mass Appraisal of Real Property* of the International Association of Assessing Officers (IAAO) considers annual assessment to be an integral component of a market-value system. But as it explains, annual assessment "does not necessarily mean, however, that each property must be reexamined each year. Instead, models can be recalibrated, or market adjustment factors derived from ratio studies or other market analyses can be applied based on criteria such as property type, location, size, and age" (IAAO 2017, 10). Annual statistical adjustments with regular cycles of full revaluation avoid the disruption and other negative consequences of long-delayed reassessments (see box 5.1).

State oversight and assistance can be crucial in ensuring accurate assessments. New York State, for example, provides local aid for state-approved reassessments on at least a four-year cycle (New York State Department of Taxation and Finance 2017). In Idaho, the State Tax Commission annually compares the verified sales prices of statistical samples of taxable real property to their assessed values. These ratio studies are used to test the results of the appraisal process, equalize the distribution of state aid, provide technical assistance to counties, and ensure compliance with legal requirements for the valuation of special classes

Box 5.1

Improving Assessment Practices in Boston

In the 1970s, the Boston property tax was a system in crisis. No citywide revaluation had been completed since the 1920s. The *National Tax Journal* asked, "How much and what kinds of unequal treatment exist in Boston?" and answered, "plenty" and "many." With assessments far out of date, prosperous areas of increasing value were undertaxed, and neighborhoods in decline were overtaxed. Nominal tax rates above 25 percent dramatized the failure of assessments to reflect anything close to market value. Although the state constitution required uniformity in taxation, residences had always been favored with lower assessment levels than business or utility property. But courts that had long accepted fractional assessment practices were increasingly willing to enforce the legal standard of uniform full value, with the potential for a dramatic shift of the tax burden to homeowners.

This situation sparked a citizen-led tax limitation initiative. Proposition 2½ limited annual increases in property tax revenue to 2½ percent and limited the property tax rate to 2½ percent. As a result, Boston was required to reduce its property tax collections by 15 percent for two years in a row. In ordinary circumstances and with accurate values, 2½ percent would be a very high tax rate, but for Boston it was an enormous—and enormously painful—change, and an incentive to revalue property. A second impetus was the ability to provide preferential treatment for residential property. A constitutional amendment permitted a limited system of differential taxation by property category, but only after the state oversight agency certified that the jurisdiction had achieved full value assessment.

In 1981, fewer than 100 of the state's 351 cities and towns had implemented market-value assessments. Four years later, 339 had done so. This was only possible in cities such as Boston by replacing the traditional system of valuation and record-keeping with computer assisted mass appraisal (CAMA). As a result, the city's assessment department was able to operate with one-third as many staff and assessment appeals dropped by more than 95 percent. The strength of the property tax system helped the city attract new business, raise its credit rating, and improve public services.

Potential homeowners view a model of a new development in Williamson County, Texas. *Source: Bob Daemmrich/Alamy Stock Photo.*

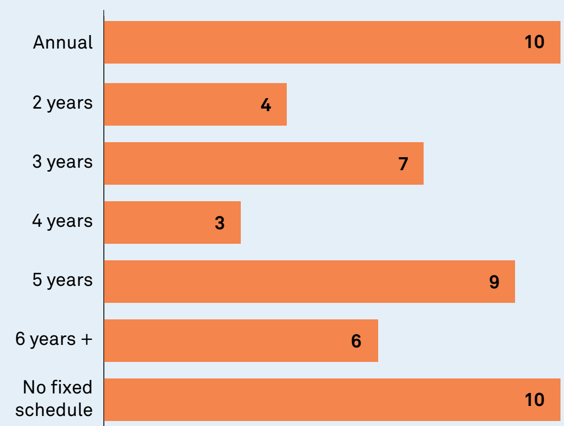
of property. By contrast, Pennsylvania provides little state supervision of county assessments; as a result, a 2007 study found that 18 of the state's 67 counties had failed to undertake a comprehensive reassessment over the past 20 years (Dornfest 2010). In 2016, 15 Pennsylvania counties assessed most properties at less than one-quarter of fair market value (Walczak, Kaeding, and Drenkard 2018).

A critical element of successful property tax administration is an effective appeals system that allows taxpayers a clear opportunity to be heard, whether to raise objections or to clarify their assessments, and to receive a response. Appeals may cover a wide range of issues, from errors in the factual description of property to disputes over valuation methods and questions of legal interpretation. For this reason, appeals systems should have separate procedures for informal consultations (e.g., correcting clerical errors or explaining available tax relief programs), in addition to administrative review of assessments by boards with valuation expertise and formal proceedings in legal tribunals (IAAO 2016). Even if appeals are ultimately taken to higher levels, an initial informal consultation can clarify the issues in contention and establish the points on which the parties agree, greatly expediting later proceedings. Ideally, most questions, complaints, and grievances can be resolved at this initial stage through face-to-face meetings, telephone conversations, or electronic communication. A study conducted in 2016 found that over 300 jurisdictions in the United States and Canada used online assessment appeals systems (Brady and Sanderson 2017). All stages of the appeals system, including the most informal, should operate according to clear guidelines on such matters as confidentiality, deadlines, and required documentation.

Regular revaluations should be accompanied by reductions in tax rates during periods of rapid growth in property values. If taxpayers fear that reappraisal at higher market value will lead to a higher tax bill, there may be political resistance to revaluation. The Truth in Taxation measures discussed in chapter 3 can encourage more responsive rate setting during periods of rising property values. In cases where there has been a long delay in revaluation, it may be necessary to phase in new assessments over three to five years to avoid rapid changes in tax liabilities.

Figure 5.2

Maximum Reassessment Cycle Allowed Under State Law in U.S. States (2017)



Note: Data based on survey responses.

Source: Dornfest et al. 2019.

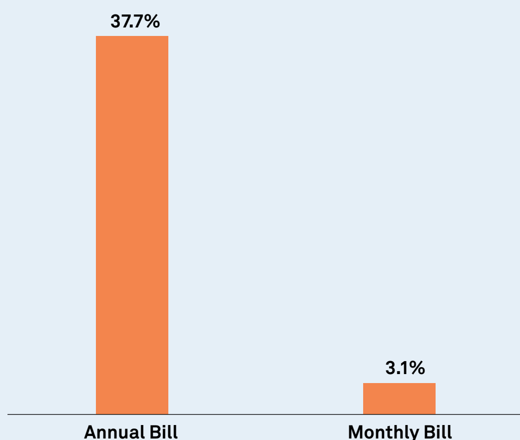
Monthly Payment Options

About half of U.S. homeowners pay their property taxes in just one or two large bills each year, which creates financial challenges for households that struggle to save for large, infrequent expenses. Local governments can allow taxpayers to pay on a monthly basis by creating a prepayment program or a monthly installment plan such as the one used in Milwaukee, Wisconsin.

The property tax is unusual among homeowners' financial obligations. While many costs of homeownership, such as utilities and mortgages, are subject to monthly billing, about half of U.S. homeowners pay their property taxes in just one or two large installments each year (Langley 2018). Receiving bills for large lump sums creates financial challenges for many households. As illustrated in figure 5.3, homeowners for whom property taxes are a manageable share of annual income can still face cash flow problems if they have not saved in advance for their tax bill. A survey by the Federal Reserve Board (2020) found that 37 percent of Americans would require a loan or other assistance to meet a $400 emergency cash expense. Homeowners who become delinquent on their property taxes typically face late-payment penalties and interest, and potentially eventual foreclosure. Being structured in large lump sums also makes the property tax unusually visible, which increases political opposition to the tax (Cabral and Hoxby 2012).

Figure 5.3

Property Tax Bill as Percentage of Monthly Income for Median Homeowner (2019)



An annual property tax bill is high relative to monthly income for a typical homeowner, so billing property taxes on an annual basis can create financial challenges for households that have not saved in advance.

Source: U.S. Department of Commerce 2019e.

Monthly or Full Payment

Monthly Installment Payment Due: February through July 2021	253.84	Net Assessed Value Rate Before Credits	FULL PAYMENT DUE ON OR BEFORE 01/31/2021	2,319.02
Monthly Installment Payment Due: August, September, and October 2021	180.87	26.167	FIRST INSTALLMENT PAYMENT DUE ON OR BEFORE 01/31/2021	253.37

2020 CITY OF MILWAUKEE COMBINED PROPERTY TAX PAYMENT COUPON

ACCOUNT TYPE: REAL ESTATE
LOCATION OF PROPERTY: 1234 W STREET AV
TAX KEY / ACCOUNT NO. 0000000000
BILL # 00000000

CHANGE IN MAILING ADDRESS (COMPLETE REVERSE SIDE)
ASSESSMENT APPEAL PENDING PAID UNDER PROTEST

Make Check Payable to:
CITY OF MILWAUKEE
OFFICE OF THE CITY TREASURER
PO BOX 78776
MILWAUKEE, WI 53278-8776

FULL PAYMENT DUE ON OR BEFORE 01/31/2021 2,319.02
FIRST INSTALLMENT PAYMENT DUE ON OR BEFORE 01/31/2021 253.37
PLEASE WRITE IN AMOUNT ENCLOSED
$
(1)

HOME OWNER
1234 W STREET AV
MILWAUKEE, WI 53202

Milwaukee offers an installment plan for property taxes, breaking the total amount owed into 10 monthly payments. *Source: City of Milwaukee.*

To avoid these problems, several U.S. jurisdictions offer monthly property tax payment options that allow taxpayers to set up automated transfers from bank accounts or mail monthly checks (Langley 2018). There are two different approaches to monthly payments. Prepayment programs are used by jurisdictions around the country, including Indianapolis, New York City, and the largest counties in Ohio (see box 5.2). These allow taxpayers to apply to make monthly payments, with their contributions accumulating in an escrow account administered by the tax collector and used to pay the annual or biannual tax bill. The second approach, used in Milwaukee, offers all taxpayers the option to pay their bill in full or in monthly installments. Taxpayers

are automatically enrolled in the monthly installment plan once they make their first monthly payment. In effect, this is a postponement of tax rather than a prepayment. Participation rates are five to ten times higher in Milwaukee's monthly installment plan than in typical prepayment programs. This is likely due in large part to the automatic enrollment without an application requirement. Among Milwaukee homeowners who do not pay their property tax as part of their mortgage, about one-third make use of the city's monthly payment option (Langley 2018).

Some jurisdictions may need a significant overhaul of their computerized payment systems in order to offer monthly payment options, but in other cases the required changes, and the costs associated with them, will be negligible. Once the collection software is in place, ongoing administrative costs are small. Transaction costs on bank account transfers can be very low, especially if the jurisdiction has opened the process to competitive bidding. Milwaukee covers these transaction costs, which are just 1.5 cents per payment (Langley 2018). Transaction costs are far higher on credit and debit cards—2.95 percent is typical—and this cost is almost always covered by the taxpayer. In the United Kingdom, which has decades of experience with direct debit payment of property taxes, tens of millions of taxpayers utilize automated payments (Hutchinson 2008), showing that regular payment options can be successful on a large scale.

Box 5.2

Monthly Prepayments in Butler County, Ohio

Ohio is a leader in the United States in allowing monthly property tax payments. As elsewhere, monthly prepayments are authorized as a local option under Ohio state law but not required statewide. However, this option has been adopted more widely in Ohio than in most other states.

Butler County, with 383,000 residents in the Cincinnati metropolitan area, has allowed monthly prepayments since the late 1980s. Under the county's free AutoPay program, taxpayers can have their monthly escrow payment automatically debited from their checking or savings accounts. For those who prefer to pay by check, the county treasurer's office sends return envelopes and "coupons" to taxpayers enrolled in the program every six months; these are perforated one-third sheets of paper with the parcel number, the estimated tax due, and other key information. If necessary, taxpayers can skip a payment and catch up in the following months without facing any penalties. In 2020, 6,065 taxpayers in Butler County made monthly payments—about 6.4 percent of homeowners not already paying their taxes monthly as part of their mortgage bill (Langley 2018; Nix 2021).

Residents of Butler County, Ohio, can have their monthly tax payments automatically debited from their bank accounts. *Source: Amy Bolinder/Wikimedia Commons.*

CHAPTER 6

Recommendations

Detail of a Maine barn. *Source: AnkNet/ iStock/Getty Images Plus.*

The property tax is the linchpin of independent local government in the United States and offers key strengths as a local revenue source. It provides stable revenue over the business cycle, it is progressive when compared to most alternatives, and its immobile tax base permits localities to set tax rates that reflect the preferences of their citizens. Like any tax, though, it faces challenges. While a number of policies can meet these challenges, they must be designed thoughtfully to address specific issues and avoid unintended consequences. The following pages offer five key recommendations to promote an equitable and efficient tax system.

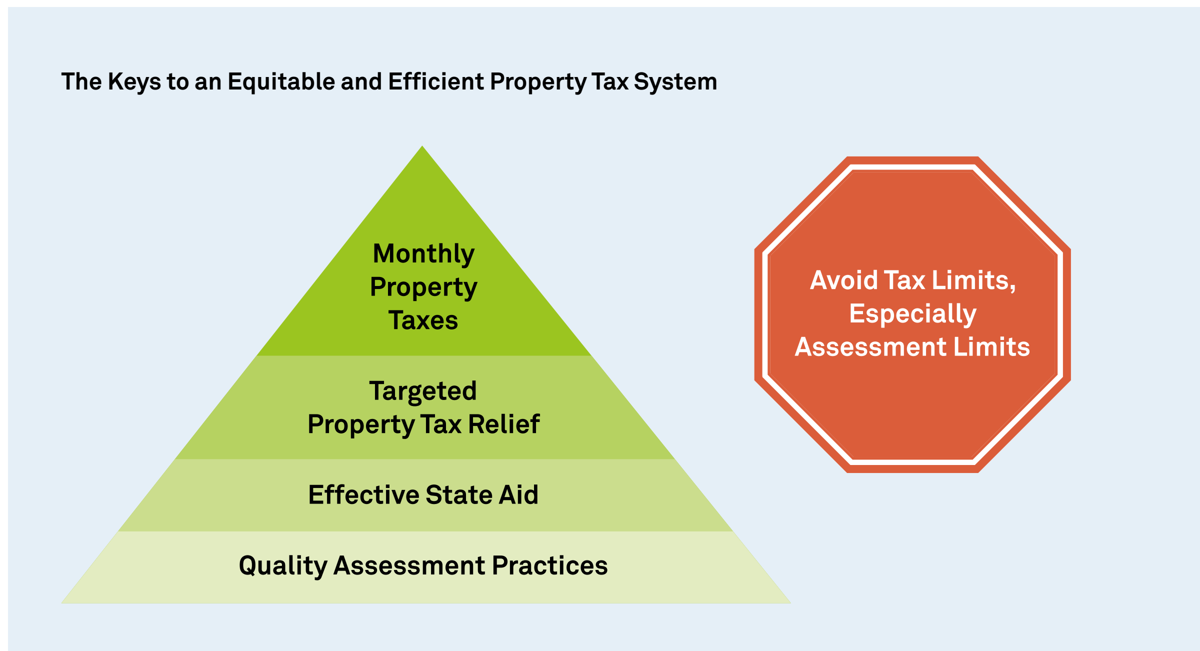
Implement Quality Assessment Practices with Regular Revaluation

Accurate assessed values are the foundation of a fair property tax system. Without accurate values, tax liabilities will be distributed in an arbitrary manner, undermining taxpayer trust in the legitimacy of the tax system. Assessment accuracy is enhanced by statistical valuation techniques, state oversight of local assessments, and effective appeals systems open to taxpayer questions and objections.

Regular revaluations are crucial to maintaining accurate assessments. Without them, taxpayers in areas of slow or declining growth will be overtaxed, subsidizing taxpayers in neighborhoods with the greatest property appreciation. Long periods between revaluation increase the likelihood that taxpayers will face sharp year-to-year tax increases. These are a primary cause of political discontent and pressure for tax limitations that often result in detrimental unintended consequences. Between full revaluations, assessments can be kept current by statistical adjustments and mass appraisal techniques.

Utilize Well-Designed State Aid Formulas

A frequent criticism of the property tax is that poorer communities with low property values cannot supply adequate public services at affordable tax rates. However, this is not a problem with the property tax, but with local taxation generally. Areas that cannot support quality services with their local tax base require transfers from a higher level of government. State aid is the only way to address these disparities and ensure that all localities have sufficient resources, especially with regard to public education. State aid formulas require careful design to achieve their goals efficiently and to avoid unintended consequences. They should take into account socioeconomic factors that affect expenditure needs and differences in the local costs of providing public services. Aid formulas should ensure that local residents bear the full costs and benefits of marginal increases in local taxes and services.



Provide Targeted and Cost-Effective Property Tax Relief with Circuit Breakers and Deferrals

Circuit breakers target relief to households paying the highest share of their income in property taxes. These may include senior citizens on fixed incomes, low-income homeowners in gentrifying neighborhoods, and workers who have lost their jobs. These programs offset taxes above a threshold percentage of income. Their focus on the most heavily burdened households is more cost-effective than offering a small amount of relief to all taxpayers.

Tax deferrals allow homeowners to delay payment of their tax until their home is sold or inherited, at which point the deferred taxes are due, together with any interest. Deferrals address the problem of taxpayers who are income-poor but housing-rich, allowing them to utilize their home equity to meet their tax obligations. These programs provide substantial assistance with very little cost to other taxpayers. They are particularly appropriate for senior citizens who wish to age in place.

Allow Homeowners to Pay Property Taxes on a Monthly Basis

The property tax is unlike almost any other tax or bill, because it is typically due in one or two large installments per year rather than being broken into smaller payments. This creates financial challenges for households that struggle to meet large, infrequent expenses, and it may increase tax delinquency. To avoid this, local governments should allow property tax payments to be made on a monthly basis. This is typically done through a prepayment program under which taxpayers apply to have their monthly payments accumulate in an escrow account. Another approach offers taxpayers the option to pay their tax bill in monthly installments.

Avoid Tax Limitations, Especially Assessment Limits

Tax limits of all types are generally a poor way to provide property tax relief. They are untargeted, they impose a one-size-fits-all limit on very different local governments, and they erode local fiscal autonomy. Limits on growth in assessed values have particularly severe unintended consequences. They create unpredictable winners and losers, they shift the tax burden from owners of rapidly appreciating property to those whose home values are growing slowly or even depreciating, they generate large horizontal inequities where owners of homes of similar value face very different tax bills, and their "lock-in" effect can reduce mobility and thus even the supply of affordable starter homes. Truth in Taxation measures are a better way to constrain growth in property taxes by requiring the same procedures for an increase in tax revenue as for a change in the tax rate, even if the revenue increase is due to rising property values.

The good news is that proven options can address common issues without undermining the strengths of the property tax.

Given the strengths of the property tax relative to other revenue options for local governments, it is better to address specific issues directly to improve and strengthen the property tax. The good news is that proven options can address common issues without undermining the strengths of the property tax. An approach that includes policies such as circuit breakers, deferrals, sound assessment and collection practices, and well-designed state aid formulas will promote a tax system that is fair and affordable for taxpayers while providing the revenue needed to maintain quality public services.

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Acknowledgments

The authors are grateful to the many experts who provided helpful comments on this report, including Gary Cornia at Brigham Young University, Margaret Cusack at the International Association of Assessing Officers, Alan Dornfest at the Idaho State Tax Commission, Ronald Fisher at Michigan State University, Roy Kelly at Duke University, Andrew Reschovsky at the University of Wisconsin, Steven Sheffrin at Tulane University, and Will Jason, Daphne Kenyon, Ronald Rakow, Semida Munteanu, and Sydney Zelinka at the Lincoln Institute of Land Policy, and extend special thanks to Katharine Wroth and Emily McKeigue for their expert editorial contributions.

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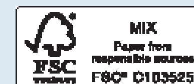

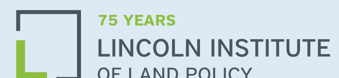

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ISBN 978-1-55844-417-1 (PDF)