Usually the Best Available Tax, but It's a Complex Question

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Introduction

The property tax is a highly unpopular tax. Not only do survey respondents consider it unfair, states across the country have long imposed limitations of various kinds on property tax revenues. Not surprisingly, local government reliance on property taxes in the United States has declined during the past few decades. In 1977, the year before California enacted Proposition 13, property taxes accounted for 81 percent of local government tax revenue and 59 percent of the own-source general revenues of local governments. In 2010, these percentages stood at 75 and 48 percent, respectively. Nevertheless, the property tax remains the mainstay of local government finance in the United States, with local government collecting $462 billion in property tax revenues in the 12 months ending July 2012 (U.S. Census Bureau, 2012).

Attempts to further restrict property tax use may accelerate in the near future. The sharp drop in housing prices in many parts of the country, the continued economic uncertainty, the aging of the population, and the retirement of the baby boom generation are all likely to increase political opposition to the property tax.

The *Point of Contention* statement implies that a shift from the property tax to alternative sources of revenue will result in a reduction in the overall efficiency and the fairness of local public finance in the United States. Although a strong case can be made on both efficiency and equity grounds for the superiority of the property tax relative to a local sales tax, continuing uncertainty about both the efficiency and incidence of the property tax prevents us from making definitive statements about the superiority of the property tax relative to a local income tax.

Efficiency

Any tax levied by a local government could potentially influence individuals to take actions to avoid the tax. As long as tax rates differ across jurisdictions, high property tax or local income tax rates may encourage households or businesses to move to a lower tax jurisdiction. If sales tax rate differentials are large, high local sales taxes are likely to encourage some consumers to make their purchases in places with lower rates.[1] Because avoiding local sales taxes is in most cases relatively easy compared with moving to a new community, one can conclude that property taxes and local income taxes are superior on efficiency grounds to local sales taxes. Comparing the efficiency of income and property taxes is much more complicated.

Whether any tax is likely to distort behavior depends on demand and supply elasticities and, consequently, on the incidence of the tax. Although economists generally agree that the burden of the income tax falls on those who earn income, the incidence of the property tax remains quite controversial. Probably the most widely accepted theory of property tax incidence is the *capital-tax view*, which was previously called the "new view." Under this view, if the supply of capital in the United States is inelastic and if all real property is taxed at the same rate, capital would flow away from real property in the long run, and the burden of the property tax would fall on all owners of capital. Under the more realistic assumption that capital will flow out of the country in response to a lower rate of return, some of the property tax burden will likely be shifted to labor.

The property tax, of course, is not a national tax, and property tax rates vary substantially. According to the capital-tax view, the incidence of the deviations from the national average property tax rate will be borne by the users of capital, because capital will tend to flow from jurisdictions with above-average tax rates to places with below-average rates. These so-called *excise tax effects* will lower wages on (immobile) labor, raise local prices (including rents), and reduce the returns to land in jurisdictions with above-average tax rates, with the opposite effect in jurisdictions with below-average tax rates. Property tax rates greater than the national average cause both household and business capital to migrate to lower tax jurisdictions. The result is an inefficient allocation of capital. Also, as Zodrow and Mieszkowski (1986a) pointed out, the potential loss of capital may lead to an underprovision of local public goods in jurisdictions with above-average property tax rates. Furthermore, the excise tax effects of above-average property tax rates may discourage investments in housing improvements. If high property tax rates are not matched by high levels of local public services, the high property tax rates will be capitalized into lower land values. Given the immobility of land, a portion of the burden of the property tax rests on current landowners. Because land is in fixed supply, these landowners are unable to take any actions to avoid the tax. As a result, the portion of the tax borne by landowners creates no distortions.

In many ways, the distortion created by a system of local income taxes would be similar to the distortion created by the property tax. Because a household's residential location and housing consumption are linked, under either system, tax rate differentials would be capitalized into housing and land prices. Oates and Schwab (2004) pointed out, however, that although both homeowners and renters pay local income taxes, fiscal illusion on the part of tenants may lead them to believe that they bear little or none of the burden of property taxation. The result, especially in cities with substantial rental property, may be an overprovision of local public goods.

An alternative theory of property tax incidence is the *benefit view*. Under this view, based on the seminal article by Tiebout (1956), homeowners choose among competing jurisdictions to find a local government that provides their desired mix of local public services at an acceptable tax rate.

[1] Within the typical metropolitan area, retail establishments tend to be concentrated in a few jurisdictions, suggesting that spatial disparities in sales tax bases are generally larger than disparities in property tax or income tax bases.

Later work by Hamilton (1975) demonstrated that using property taxes to fund local governments, combined with a system of zoning, can guarantee an efficient allocation of local public goods. In a setting where mobile households choose among a set of different jurisdictions, the property tax effectively serves as the price households pay for their preferred mix of local public services.

Would the replacement of the local property tax with a local income tax lead to an increase in economic distortions generated by taxpayers choosing to work less or choosing to move to lower tax rate jurisdictions? As Oates and Schwab (2004) argued, if housing consumption is perfectly correlated with income, then the income tax would be converted into a perfect benefit tax, again resulting in an efficient allocation of local public goods. In reality, we do not expect the correlation between income and housing consumption to be perfect. The result is that a local income tax will generate some efficiency loses. Based on a general-equilibrium model, however, Goodspeed (1989) suggested that the efficiency losses from a local income tax would be relatively modest.

One important difference between a local property tax and an income tax is that property taxes are levied on the owners of all types of property, whereas income taxes are levied only on residents and perhaps commuters. Thus, a switch from property taxation to individual income taxation would eliminate most taxation of commercial and industrial property. An efficient system of local public finance would tax local businesses at a level equal to the marginal costs of the local public services they receive. The failure to tax business would thus be expected to result in an inefficient allocation of resources.

Although we can conclude that the property tax is a relatively efficient local government tax, the limitations on assessment growth and on property tax levies and rates imposed by state governments or voter-initiated state constitutional amendments can create economic distortions. For example, annual limits on the growth rate of assessed values found in a number of states, including California, have created *lock-in effects*, which distort behavior by discouraging long-time homeowners from selling their homes. However, as McGuire (2001) pointed out, if the property tax were replaced by a local income or sales tax, it is highly likely that, over time, state legislature would also impose inefficiency-creating limitations on these taxes.

Equity

Any tax that "bears less harshly on those less able to afford it" is considered a *progressive* tax. In a recent paper, Fischel, Oates, and Youngman (2011: 1) asserted that despite 50 years of analysis, "our understanding of the incidence of local property taxes is in a sad state." On the one hand, in enacting property tax relief measures targeted at households with low incomes, state and local government policymakers frequently assert that the property tax is unfair because low-income households tend to face heavier burdens than households with higher incomes. Underlying these statements is a belief that statutory incidence determines the distribution of tax burdens and that housing expenditures as a fraction of income are greater for low-income than high-income households.

On the other hand, many public finance economists accept the capital-tax view of property tax incidence. According to this view, from a national perspective, the average rate of property taxation generates a burden on all owners of capital. Because capital ownership is highly progressive, the incidence of this portion of the tax is also progressive. Because property tax rates vary substantially across the country, the burden of the positive and negative deviations around the average, referred to as the excise tax effects, fall on immobile factors such as landowners, local consumers, and labor. Supporters of the capital-tax view argue that, in the aggregate, the negative and positive excise tax effects cancel each other out (Zodrow and Mieszkowski, 1986b). Thus, we can conclude that from a national perspective the complete burden of the property tax falls on capital and is therefore progressive.

Supporters of the benefit view reject this conclusion. They argue that because the property tax is only the price that households pay to receive their desired mix of local public services, the question of tax incidence, or fairness, is not relevant.

I argue that policymakers and most economists tend to underestimate the complexity of the property tax incidence issue. These assertions about the incidence of the property tax do contain some truths. I will attempt to demonstrate, however, that no blanket statement about property tax incidence is justified; a more nuanced approach is necessary.

For several reasons, policymakers tend to overestimate the property tax burdens faced by low-income households. Policy debates are primarily focused on the property tax paid by homeowners (their statutory liability), and it appears that most policymakers assume that the entire burden of the tax falls on the owners, failing to recognize or acknowledge the capital-tax view that, in the long run at least, a portion of the tax burden will be borne by all owners of capital.

Empirical studies based on the statutory incidence of the property tax tend to overestimate the regressivity of the property tax on homeowners.[2] In these studies, average tax burdens are calculated by dividing statutory tax liabilities for a single year by a measure of annual household income. It is well recognized that calculating tax burdens based on annual data leads to an annual income bias. The argument, originally made by Friedman (1957), is that in cases such as housing, wherein consumption decisions are made on the basis of long-run income, calculating tax burdens using income data for a single year will yield far greater tax burdens for low-income households than burdens calculated on the basis of long-run or lifetime income. These differences in tax burdens occur because many people who have low incomes in any given year are only temporarily poor. Conversely, the use of annual income will bias average tax burdens downward on high-income households as long as some households with high annual incomes are only temporarily rich.

The empirical literature includes several attempts to account for the effect of the annual income bias when calculating tax burdens. Metcalf (1994) and Poterba (1989) used annual expenditures as a proxy for lifetime income. Chernick and Reschovsky (1997) criticized the use of expenditure data as an indicator of lifetime income and proposed the use of data on income and tax payments over a period of at least several years. Using longitudinal data on income and property tax payments covering a period of 11 years, Chernick and Reschovsky (1993) found that the property tax burden on homeowners remains mildly regressive. In a recent study of property tax burdens on homeowners, Boldt, Caruth, and Reschovsky (2010) calculated tax burdens using 6 years of

[2] One example of a study that provides state-level estimates of the distribution of state and local taxes, including the property tax, is Davis et al. (2009).

income and tax data and a comprehensive measure of income that included an estimate of imputed rents. Compared with tax burden calculations based on annual data, property tax regressivity was reduced but not eliminated. Metcalf (1994), who assumed that capital bears the burden of the property tax, found that the highest tax burdens remain on households in the two lowest income quintiles (in his case, with income measured by annual expenditures).

According to the capital-tax view of property tax incidence, the excise tax effects borne by local consumers, landowners, and workers will cancel each other out. The validity of this statement depends on empirical evidence about the relationship between effective property tax rates and income. If property tax rates are uncorrelated with income, then from a national perspective the excise tax effects cancel out and the property tax can be seen as a progressive tax on capital. Not surprisingly, given the absence of a national dataset on effective property tax rates, very little empirical evidence exists at the national level on the spatial correlation between effective tax rates and incomes. A study of this question by Aaron (1975) is now out of date. Gravelle (2007: 889) found that "the excise tax effect of the property tax neither strongly increases nor decreases the progressivity of the property tax as a whole." This finding led her to conclude that the property tax can "continue to be viewed as a general tax on capital" (Gravelle, 2007: 890). Unfortunately, the Gravelle study was based on somewhat questionable estimates of the average effective property tax rate by state. The property tax is a local government tax, and the intrastate variation in rates may well exceed the interstate variation measured by Gravelle.

Even if future research confirms that, across the nation, effective property tax rates are uncorrelated with income and therefore that the excise tax effects have no net effect on tax progressivity, the question remains whether it makes any sense to think about property tax incidence from a national perspective. The property tax in the United States is a local tax. All policy decisions related to the property tax are made at the local government level or, in the case of tax limitations or assessment rules, at the state government level. In a state with above-average tax rates, local property owners, consumers, and labor bear part of the burden of the tax. The effect of the tax on these local residents will likely influence property tax policy in that state. The fact that taxpayers in states with below-average tax rates benefit from offsetting excise tax effects seems largely irrelevant to any policy discussions related to the property tax in high-tax locations.

To the extent that excise tax effects influence the incidence of the property tax in any given state, it is worth noting that the distribution of tax burdens can also be influenced by various institutional factors. As shown by several studies conducted in the 1970s and 1980s, property tax assessment practices can substantially reduce the progressivity of the tax by systematically assessing low-value properties at a higher proportion of their value than high-value properties. On the other hand, many states have enacted circuit breakers and other property tax relief policies designed to reduce the net property tax burden of certain, often low-income, households.[3] Finally, the ability of taxpayers who itemize their deductions on their federal returns to deduct property tax payments serves to reduce the net burden of the property tax, especially on taxpayers with moderate to high incomes.

[3] No comprehensive studies appear to have tried to calculate the degree to which targeted tax relief measures have reduced property tax burdens. In a study of property tax circuit breakers, Bowman et al. (2009) reported that, in most states with circuit breaker programs, the value of total tax relief was less than 2 percent of state property tax collections. Only in New Jersey and Michigan did the cost of circuit breaker programs exceed 5 percent of total collections.

In an interesting paper, Nechyba (2001: 119) concluded his analysis of the two views of property tax incidence by stating that "there may not be one right model. The different assumptions underlying the two different views are likely to hold to varying degrees from one setting to another; one view may be more appropriate in one case than in another." Fischel, Oates, and Youngman (2011) took Nechyba's suggestion and attempted to explicitly define the settings in which each view is most appropriate. They argued that the benefit view fits best in suburban portions of metropolitan areas, but the capital-tax view is most appropriate in cities and in rural areas.[4] They also point out that in states, such as California, where public education financing is primarily conducted by the state government and local governments are prevented from raising property taxes to increase spending on local public goods, the benefit view is weakened.

Although it is not possible to make a general statement about the progressivity of the property tax, it is possible to speculate that the replacement of the property tax with a local sales tax would, in the average state, increase tax burdens on those households with limited resources, and the substitution of a local income tax for the property tax may slightly reduce the tax burden on low-income households.

Economists generally agree that the burden of the sales tax rests primarily on consumers and the burden of the individual income tax on income earners. The progressivity of each tax, however, varies substantially across states depending on the breadth of the sales tax base and the tax rate structure, exclusions, exemptions, and deductions that define local income tax system in each state. The distributional analysis of state tax systems conducted by the Institute of Taxation and Economic Policy (Davis et al., 2009) indicated that state and local sales tax distribution is regressive in every state, although the burden on households in the bottom income quintile varies substantially even when comparing states employing identical sales tax rates. Although state income tax systems are at least mildly progressive, local income taxes, where they exist, are usually levied at a flat rate on only earnings or payrolls, and thus they may be somewhat regressive when calculated relative to a broad measure of ability to pay.

Conclusions

The *Point of Contention* statement asserts that the property tax is superior to alternative local government revenue sources on both equity and efficiency grounds. I have tried to make the case in this article that any comparison among local government revenue sources is complicated by the fact that no definitive statement about either the efficiency or the equity of the property tax is justified. Given the current state of both the theory and the empirical evidence related to the property tax, I think the best approach is to accept that both the efficiency and equity of the property tax will be different in different settings.

It is nevertheless possible to reach a few general conclusions. On both efficiency and equity grounds, the property tax and the local income tax are preferable to the sales tax in many settings. Not only is the sales tax likely to place heavier burdens on low-income households than the other

[4] The authors pointed out that, in locations where the benefit view is most likely to hold, a local income tax would also tend to operate as a benefits tax.

two taxes, it makes tax avoidance much easier. Comparisons between the property tax and the income tax are much more difficult, although on efficiency grounds the property tax may dominate the income tax in many settings.

Note that the property tax does have several advantages over other local government revenue sources on grounds not directly related to efficiency or equity. First, property tax revenues have tended to be much more stable over business cycles than revenue from local sales or income taxes. The past decade has demonstrated the importance of stable local government revenue sources. Sharp declines in state government tax revenues following the recessions of both 2001 and 2007 through 2009 led to large cuts in state fiscal assistance to local governments. Without a relatively stable source of local government revenue from the property tax, local governments would undoubtedly have had to cut services even more than they did. Second, for property owners without escrow accounts, the fact that annual property taxes are usually made in one or more large installment payments increases the salience of the tax. Although the visibility of the property tax undoubtedly increases opposition to the tax, it has the positive effect of enhancing taxpayers' awareness of the cost of local government. As a result, they are more likely to demand efficient public service provision by their local government. This awareness of the costs of government may be less true in the case of income taxes withheld from paychecks or sales taxes collected from individual transactions.

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