Property Tax Reform: New Wheels for an Old Pumpkin?

BY JOHN CLAPP* AND
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The New England colonies quickly adopted various forms of property taxation to finance public services and projects that were likely to increase property values. Through participation in town meetings, town councils, and "home rule"—classic New England institutions—citizens grabbed the local tax and spending reins. Yet, ever since, Connecticut residents and their representatives have debated the merits and flaws of the local property tax. Current reformers range from those who see the tax as the enemy of open space (presumably because it encourages towns to raise revenue by seeking development) to those who champion cuts in all taxes as a way to limit government's role.

West Hartford's 2005-06 revaluation highlights the problems associated with the venerable property tax and some key issues in the reform debate. Given the problems, including the "sticker-shock" effect of infrequent revaluations, it may be time to employ fairer and less costly assessment practices and to consider other sources of local funding.

UGLY PUMPKIN OR GLISTENING COACH?

On the surface, property taxes hardly look "fair." In 2005-06, the equalized mill rate (EMR)—essentially the dollars of tax per $1000 of a property's market value—ranged from 4.72 in Greenwich, to 27.89 in Waterbury, nearly a six-fold difference. For each of Connecticut's 169 towns, the graph shows the relatively strong negative relationship between the EMR and per capita income. Residents of poorer towns like Bridgeport, Hartford, New Haven, and Waterbury tend to pay higher effective property tax rates than residents of wealthier towns. Why? Simple: wealthy towns typically have more taxable property per head, requiring a lower rate to produce a given tax revenue (= rate x assessed value). Poorer towns must tax their property-poor residents at a higher rate to generate a similar, or often even smaller, revenue per person.

Because lower-income persons often face higher EMRs and spend larger shares of their incomes on property taxes than those better off, some economists view the property tax as "regressive." Others claim that progressive local spending programs, targeted at the poor, tend to offset property tax regressivity. Whatever one's view of the matter, property tax rates are far from uniform, and this has become an argument for either equalizing communities' property tax rates or funding local services with a higher-level tax levied by counties, regional authorities, or states. California (Proposition 13), Massachusetts (Proposition 2.5), and many other states have passed laws to limit local property tax rates, and as a result state governments have expanded their payments for education and other basic services.

Even *within* a town, effective property tax rates often differ. The town's nominal or simple mill rate—dollars of tax per $1000 of *assessed* value—applies equally to all owners of a given property type. Assessments in Connecticut are legally supposed to be a constant fraction (70%) of market value, but if they are not, the effective or equalized mill rates will differ across properties.

A simple example helps to see this point. Nick's $200,000 property is

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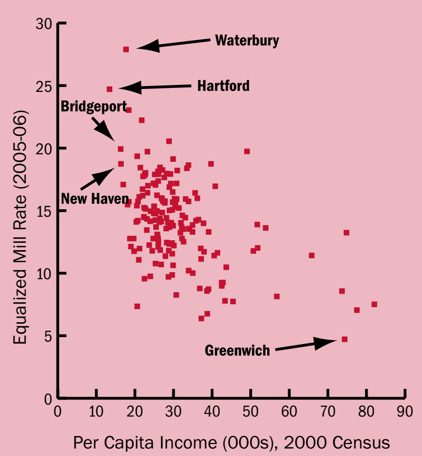
HIGHER INCOME TOWNS FACE LOWER PROPERTY TAX RATES



SOURCE: *The Connecticut Economy*, based on data from the Office of Policy and Management and U.S. Census Bureau.

new and upon completion was correctly assessed at $140,000, or 70% of market value. Andy's older property—difficult to value because of its age, location, and unique features—has an assessed value of only $100,000 but would also fetch $200,000 in today's market. If the town's simple mill rate is 25, Nick will pay $3,500 (= 25x140), while Andy will pay only $2,500 (= 25x100). So Nick's taxes exceed Andy's by 40%, even though both properties have the same market value. Such discrepancies, arising from inaccurate property assessments, delayed revaluations, etc., can be another source of inequities and costly disputes in the administration of property taxes.

MORE WARTS

Besides the uneven and perhaps regressive nature of the property tax, it has some other unattractive features. *First*, traditional methods of property valuation, based on home inspections and reviews of property records and comparables, can be costly, one of the reasons why towns drag their feet in complying with state mandates to regularly revalue. *Next*, the possibility that a property is currently under-taxed or over-taxed—and that, come revaluation time, the distortion may be suddenly corrected—creates uncertainties that inhibit property trades and rational investment in property improvements. *Finally*, the decentralized system of local public finance and spending, relying on the property tax as the main revenue source, makes it difficult to address regional issues of transportation, environmental quality, open-space preservation, hazardous waste disposal, and the siting of prisons, dumps, and other unattractive but necessary facilities.

...AND SOME BEAUTY SPOTS

The property tax is not all warts and wrinkles. Before we discard it, or substantially limit its role, we should note some good points of the tax that help to explain its widespread use and durability.

Any tax prompts efforts to avoid payment or to reduce its take. The visibility and immobility of real property make it more difficult to avoid a property tax than a tax on income, financial assets, or the sale of merchandise. And unlike those other taxes, the services funded by the property tax (e.g., local education, police services, fire protection, parks and playgrounds) are closely tied to local tax payments.

In fact, the tax encourages local responsibility and oversight, because money spent efficiently increases the wealth of local property owners. Efforts to supplement local revenues with state-aid or other transfers may redress inequities or "level the playing field" among communities, but they also blur the useful link between local services and taxes and discourage local self-reliance. Property taxes give towns a measure of control that vanishes in more centralized public finance systems, and that extra control encourages taxpayer oversight and involvement because of the perceived personal stake in local taxes and spending.

Finally, when local governments set their own property tax rates and spending levels, households locating in a region have more options for the type of community they select—a "shopping" process, artfully described more than 50 years ago by economist Charles Tiebout, that also provides incentives for local governments to be more efficient.

A WEST HARTFORD STORY

Like all Connecticut towns, West Hartford relies heavily on the property tax to finance its local services. Ninety percent of its revenues flow from the tax, and the residential share of the tax stream is more than 3/4. West Hartford revalued its property in 2005-06; the previous revaluation occurred in 1999. This revaluation lag is common, and not even very long by some standards: Waterbury went 21 years between revaluations, from 1980 to 2001 despite a Connecticut statute, at that time, requiring local revaluations at least every 10 years.

West Hartford's revaluation illustrates well the property tax distortions that crop up over time, even within a single jurisdiction. When revaluations occur, many things can change: individual assessments and tax burdens; shares of the budget paid by different property classes; and, as in any tax year, the mill rate and the overall level of spending.

Individual burdens are complex and not the focus here, but we can see how payments changed in West Hartford for various classes of property due to revaluation. To isolate the "revaluation effect," we posed the question: If West Hartford had set a 2006 mill rate to maintain its 2005 spending level of $166.88 million, but levied taxes according to the new assessed values that went on the books on October 1, 2006, how would the tax payments by each property class have changed simply because of revaluation?

The table shows that revaluation alone boosted residential tax payments by 9.54% and reduced commercial tax payments by 9.20%, with proportionately larger reductions of 37.96% and 36.75% in the payments for personal property and motor vehicles. Thus, *prior* to revaluation residential property was *undertaxed* and commercial property was *overtaxed*. The commercial-to-residential tax shift that occurred with revaluation is typical of towns over the past 10 years and helps to explain both voters' opposition to revaluations and the reluctance of elected officials to confront the issue.

But as unpopular (with households) as more frequent revaluations

WEST HARTFORD'S REVALUATION EFFECT
($millions)

Property Class	Taxes Based on 2005 Value	Taxes Based on 2006 Value	Percent Change
Residential	116.19	127.28	9.54%
Commercial	27.67	25.12	-9.20%
Personal	6.69	4.15	-37.96%
Motor Vehicle	16.33	10.33	-36.75%
Total	**166.88**	**166.88**	**0%**

SOURCE: Town of West Hartford

seem to be, there are some strong economic arguments for them. Shorter revaluation cycles would entail smaller and more palatable adjustments, avoiding much of the "sticker shock" that residents face. A smoother flow of tax payments over time also would reduce uncertainty and enhance the efficiency of property markets.

In addition, more frequent revaluations would necessarily rely more heavily on "statistical" as opposed to "physical" revaluations. Economists and statisticians have developed and refined "hedonic" models of house prices that measure the relationship between market values and the physical and site characteristics of houses. Once the relationship has been established, it's straightforward to apply the model to each property, with its own set of characteristics, and thereby estimate its market value. When put to the test of the market, such models generally prove to be reasonably accurate and relatively cheap to update and apply.

A WAVE OF THE WAND?

It may be wishful thinking to expect a Cinderella-like transformation of local property taxation—one that might significantly reduce current problems. Besides, some makeovers just aren't enough to fully solve the problems. Given its troubled history and the seemingly widespread dissatisfaction with the tax, perhaps we also should be considering other revenue sources for local governments.

In some states, like New York, cities have the option to tax income as well as property. Such taxes often "piggy-back" on state income taxes, facilitating computation and compliance. If Connecticut were to grant this authority to towns, an unresolved issue is whether localities would only be allowed to impose a tax that is a uniform (across towns) percentage of state or federal tax liabilities or one that might vary by town. It should be noted that a local income tax would likely shift the emphasis away from property taxation, unlike proposals to increase state income tax credits for local property taxes, which encourage more property taxation to cash-in on the tax credit.

Arguably more progressive than property or sales taxes, a local income tax might address a perceived weakness of the current property tax system. The income tax also is less subject to the sharp adjustments that accompany property taxes, especially those that rely on infrequent property assessments. And, to address broader needs, a portion of local income tax receipts might be earmarked for regional projects.

But income taxes are not without their own problems. Unlike the property tax, an income tax doesn't stimulate an interest in local affairs because it is relatively easy to move one's human capital away from high-tax jurisdictions. Also, many folks regard two income taxes—federal and state—as two too many, so the challenge of selling politicians and their constituents on a third one is formidable.

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REALISTIC GOALS

In the end, efforts to reform or reduce our reliance on local property taxes should consider the weaknesses and strengths of the tax. In particular, a smoother and more gradual process of revaluation, with greater reliance on well-tested statistical methods, would do much to reduce the within-town inequities and the uncertainty created by delayed but abrupt revaluations. It's not clear that effective property tax rates should be forcibly equalized between jurisdictions. Peoples' different tastes for public goods and their unequal willingness to pay for them argue strongly for a range of community choices. The best way to redress the inter-town inequities and regional needs may be to replace some of the property tax with a progressive local income tax and some regional pooling of revenues to address problems that affect groups of towns with common interests.

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