International Studies Program

International Studies Program
Working Paper 08-22
December 2008

Fairness and Market Value Property Taxation

Steven M. Sheffrin

Georgia State University

Andrew Young School of Policy Studies

Georgia State University | ANDREW YOUNG SCHOOL OF POLICY STUDIES

International Studies Program
Working Paper 08-22

Fairness and Market Value Property Taxation

Steven M. Sheffrin

December 2008

International Studies Program
Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
United States of America

Phone: (404) 651-1144
Fax: (404) 651-4449
Email: ispaysps@gsu.edu
Internet: http://isp-aysps.gsu.edu

Copyright 2006, the Andrew Young School of Policy Studies, Georgia State University. No part of the material protected by this copyright notice may be reproduced or utilized in any form or by any means without prior written permission from the copyright owner.

Georgia State University | ANDREW YOUNG SCHOOL OF POLICY STUDIES

International Studies Program
Andrew Young School of Policy Studies

The Andrew Young School of Policy Studies was established at Georgia State University with the objective of promoting excellence in the design, implementation, and evaluation of public policy. In addition to two academic departments (economics and public administration), the Andrew Young School houses seven leading research centers and policy programs, including the International Studies Program.

The mission of the International Studies Program is to provide academic and professional training, applied research, and technical assistance in support of sound public policy and sustainable economic growth in developing and transitional economies.

The International Studies Program at the Andrew Young School of Policy Studies is recognized worldwide for its efforts in support of economic and public policy reforms through technical assistance and training around the world. This reputation has been built serving a diverse client base, including the World Bank, the U.S. Agency for International Development (USAID), the United Nations Development Programme (UNDP), finance ministries, government organizations, legislative bodies and private sector institutions.

The success of the International Studies Program reflects the breadth and depth of the in-house technical expertise that the International Studies Program can draw upon. The Andrew Young School's faculty are leading experts in economics and public policy and have authored books, published in major academic and technical journals, and have extensive experience in designing and implementing technical assistance and training programs. Andrew Young School faculty have been active in policy reform in over 40countries around the world. Our technical assistance strategy is not to merely provide technical prescriptions for policy reform, but to engage in a collaborative effort with the host government and donor agency to identify and analyze the issues at hand, arrive at policy solutions and implement reforms.

The International Studies Program specializes in four broad policy areas:

- Fiscal policy, including tax reforms, public expenditure reviews, tax administration reform
- Fiscal decentralization, including fiscal decentralization reforms, design of intergovernmental transfer systems, urban government finance
- Budgeting and fiscal management, including local government budgeting, performance-based budgeting, capital budgeting, multi-year budgeting
- Economic analysis and revenue forecasting, including micro-simulation, time series forecasting,

For more information about our technical assistance activities and training programs, please visit our website at http://isp-aysps.gsu.edu or contact us by email at ispaysps@gsu.edu.

Fairness and Market Value Property Taxation[1]

Steven M. Sheffrin
Professor of Economics and Dean, Division of Social Sciences
UC Davis

[1] Paper prepared for the Andrew Young School of Policy Studies, Georgia State University and the Lincoln Institute Conference on Property Taxation held at Stone Mountain, Atlanta April 27-29, 2008. This research was supported by the Center for State and Local Taxation at UC Davis.

There are two incontrovertible facts about property taxation.

The first fact is that the property tax is the economist's favorite mechanism to finance local government. Let us count the disparate and not fully consistent ways:

- In an age of increased taxpayer mobility and limits to the reach of taxing authorities, the base of the property tax is relatively immobile and one component of the base, land, is totally immobile. That led Henry George, drawing on the insights of David Ricardo, to proclaim it the ideal "single tax" and animates the vision of "value capture" by Latin American tax theorists.[2]
- In an age of increased immigration and an emphasis on diversity, the property tax can serve effectively as a local tax in which residents choose the size, scope, and quality of public services. Drawing on the insights of Charles Tiebout, Bruce Hamilton and others demonstrated how, under certain conditions, property taxation combined with local zoning could lead to an efficient decentralized benefit system of taxation with minimal economic distortions.[3]
- In an age of increased inequality, the property tax can be seen as a progressive tax. According to the "new view" of property taxation, the average tax rate across communities effectively serves as a tax on capital. Deviations from this average are more akin to excise taxes. At the least this average component functions as a tax on capital, which most economists believe is more progressive than a tax on wages or, its main local alternative, the sales tax.

[2] For the Latin American perspective, see the summary in See Smolka and Furtado (2001).

[3] For a discussion and references, see Oates (1999).

- In an age of political turmoil, there is a frequent call for transparency in government. Property tax burdens are not "hidden taxes" designed by a malevolent Leviathan, but yearly lump sum billing makes the taxpayer confront the cost of governmental services. Property tax records, unlike income or sales tax payments, are on the public record.
- To the extent that economists have reservations about the property tax, they tend to focus on its administration. The ideal base for most economists is the current market value of property. Deviations from this base can occur for a variety of reasons, including infrequent reassessment, poorly trained assessors, and, most significantly, limits imposed by legislatures or by popular referendums that sever the link between market and assessed values.

The second fact is that the taxpaying public hates the property tax. Surveys consistently show low public regard for the property tax. For example, the Tax Foundation's *2006 Annual Survey of U.S. Attitudes on Tax and Wealth* found that 39% of respondents characterized the property tax as "the worst tax—that is, least fair" of state and local taxes, compared to 20% for state income taxes, 18% for sales taxation, and 7% for the state corporate income tax.[4] Only in 2007 as gasoline prices began to rise did the public find a tax—the gasoline tax—that they liked less than the property tax.[5]

Taxpayers put this dislike of the property tax into action. The nation's tax dialogue resonates with names of taxpayer actions to limit the scope of property taxation—"Proposition 13" and "Proposition 2 ½" are some of its most famous phrases.

[4] These and related data can be found in Tax Foundation (2006).

[5] Estate taxes were the most disliked of all taxes in the 2007 survey. See Tax Foundation (2007).

Taxpayers have put in a variety of ingenious limits on property taxation—by one account in 2006 only 5 of the 48 states of the continental United States had no limits.[6] And limits on property taxation are not just a postwar phenomenon. The birth of state sales and income taxes in the 1930s in the United States was driven by the same forces that led to reduced property taxation.[7] Nor does the voting public share the fondness that economists have for market value property taxation. Many of the most famous property tax limits, e.g., the assessment growth limitations in California and Florida, are explicit in breaking the link between market and assessed values.

This paper presents an extended argument that the public's feelings towards the property tax are based on an underlying legitimate concern over the fairness of market value taxation. While other factors may certainly operate, both the public opinion polls and taxpayer actions can be partially explained by an inherent distaste for market value taxation.

Navigating the shoals of "tax fairness" is not an easy voyage—it is easy to get detoured in discussions of philosophy, psychology, politics, conventional economic theory, and behavioral economics.[8] To avoid these detours, here is a brief roadmap of the argument in this paper.

The argument proceeds in four steps. I first review the traditional criteria for fairness in taxation in light of some recent critiques of the conventional approach. I argue that tax fairness needs to be examined on a tax-by-tax, bottom-up approach that respects the details of each tax, and preserves the conventional criteria for evaluating tax fairness.

---

[6] See Anderson (2007).

[7] For a discussion of this phenomenon in California, see Hartley, Sheffrin, and Vasche (1996)

[8] For an earlier discussion of tax fairness, see Sheffrin (1994).

The second part of the argument is that there is an inherent conflict between the two traditional approaches to taxation—ability to pay and the benefit principle that are most dramatic in the context of property taxation. The third part of the argument is that with a fixed revenue target, any changes in market values of property merely shift individual tax shares. Psychological studies suggest that this violates norms of fairness and ignores the affective ties individuals have towards property. From an economic point of view, the uncertainty of individual tax shares produces additional risk that taxpayers will seek to mitigate. The final part of the argument is that there are non-market value property tax systems that both balance the ability to pay and the benefit principle as well as reduce individual risk of shifting tax shares. An example, albeit imperfect, is the banded property tax system in effect in the United Kingdom. The paper explores the strengths and weakness of this system, including its progressivity and suggestions made for its reform. Banded property tax systems, which deviate from market value taxation, may indeed be the most "fair" of all property tax regimes.

1. What is Fairness in Taxation?

The traditional workhorses that economists and tax law professors use to analyze fairness are the concepts of horizontal and vertical equity. Horizontal equity means treating equally situated taxpayers equally while vertical equity means that higher income taxpayers should face higher tax burdens. Although these criteria have often been viewed as too weak to prescribe policies, some commentators have taken another approach and challenged whether they have any independent validity whatsoever. Since vertical equity

depends on horizontal equity as a base, critiques have focused on the concept of horizontal equity.

In a recent book, *The Myth of Ownership*, Liam Murphy and Thomas Nagel (2002) take the position that horizontal equity is not a robust theory of tax fairness. While their book delves deeply into social and political theory and theories of distributive justice, they make a relatively straightforward critique of horizontal equity. In their view, there is nothing morally ordained about pre-tax distributions of income. If that is indeed the case, what moral base is there to suggest that deviations from the pre-tax distribution that favor one party are inherently unfair? Although to the untutored eye, pre-tax distributions may appear part of the natural order, those same pre-tax distributions are governed by a complex array of social and governmental policies—including tax policies—and do not simply arise from a neutral state of nature.

Economists have also been critical of horizontal equity as an independent mechanism for judging tax fairness. Complex judgments need to be made to determine if two parties are, in fact, situated equally. Would the recipient of $100,000 in workers compensation after an accident be similarly situated to a non-injured worker earning $100,000? Or, in another classic example, should a family with two adults and two children but only one worker be treated equally to a similar family with two workers? Clearly, judgments need to be made independently to determine if parties are similarly situated. If that is the case, why have a separate theory of horizontal equity?

Brian Galle (2008) presents an alternative justification for an independent role of horizontal equity from the perspective of the legislative process. In his view, raising revenue is a primary function of the tax system. Horizontal equity "enshrines the status

quo" from previous market and governmental interventions and allows the revenue functions to proceed without constantly returning to first principles of redistribution.[9] If every debate about a new tax or a change in an existing tax rate required a thoroughgoing debate about income distributions, the legislative process could easily become totally dysfunctional. Although participants recognize that tax choices do affect distributions, they are willing to place limits on these debates to facilitate an efficient legislative process. Galle's argument tackles the Murphy-Nagel critique but difficulties of defining "similarly situated" parties still remain.

How might these arguments apply to assessing the fairness of market value property taxation? At one level, one might think that the Murphy-Nagle arguments apply especially to property which receives protections from the state and whose distribution is clearly a function of social and governmental policies and practices.

Yet, there is an important difference between fairness of taxation in general and fairness of particular taxes. Most of the grand debates about distributive justice naturally focus on the cumulative effects of the tax system as a whole and, often in their tone, seem implicitly directed to income taxation. The questions that are addressed in these debates are the sufficiency of resources for the least well off in society or, perhaps, the role of the very rich in society. These are typically best addressed through income (consumption) taxes perhaps coupled with estate or inheritance taxes.

Yet, everyday citizens confront a variety of other taxes besides federal income or estate taxes: sales taxes, excise taxes, user charges, state income taxes, and property taxes. And, as the surveys show they have clear opinions on the operation and fairness

[9] Galle (2008) provides a nice review of prior work on horizontal equity. He uses the term "enshrine the status quo" in the abstract to his paper.

of these taxes. Citizens are concerned with the burden and equity of each of these taxes. They are substance of their daily frustrations—after all these are taxes—and their comparisons with neighbors, colleagues, and strangers. With respect to property taxes, as citizens they have expressed strong opinions through the ballot boxes, limiting particular taxes but not others.

Galle's general approach to horizontal equity can also be useful here. When we look at the operation and fairness of particular taxes, we put on hold our broad distributional judgments about the economy as a whole. We may reserve those for once in a generation debates about macro distributions, but in daily discourse we focus on the burden and fairness of individual taxes. This allows taxpayers and public officials to zero-in on the complex operation of taxes and how they impact businesses and homeowners differentially. Otherwise, we could not truly focus on how these taxes actually work and develop new policies and approaches that can correct malfunctions or inefficiencies in our fiscal systems. That is not to suggest grand ideas of distribution do not color one's view of particular taxes, but that operates at a background level. Tax policy is complex and has major economic consequences—our political energies need to be focused directly on the operation of these taxes. And fairness, as perceived by taxpayers and voters, needs to be focused on individual taxes.

The Supreme Court uses a very weak view of horizontal equity in its jurisprudence. Wood (2006) distinguishes between substantive and systemic horizontal equity. Substantive horizontal equity bases comparisons of taxpayers relative to their income or wealth and mirrors the use by economists of the concept. Systemic horizontal equity, on the other hand, focuses on the consistency, regularity, and certainty of

application. In his examination of Supreme Court jurisprudence, including cases on property taxation, Wood relies primarily on this concept of horizontal equity, not substantive horizontal equity.[10] The courts have been most concerned with fair procedure, not fair outcomes as measured by an objective standard.

In the property tax arena, this distinction is clear in the Supreme Court's differing rulings in *Allegheny Pittsburgh Coal Co. v. County Commission* and *Nordlinger v. Hahn*.[11] In the former case, a West Virginia county assessor generally made major revaluations of properties only upon sale whereas the second case challenged the provisions of Proposition 13, which also only allows major revisions of assessed value upon sale. In both cases, there were "substantive" horizontal inequities between similar properties based on the date of sale. Yet, the Supreme Court ruled in favor of the taxpayer in *Allegheny* but for California in *Nordlinger*. The primary reason was that in California, the assessment provisions had been adopted by law, whereas in West Virginia, state law called for uniform assessment at market value but the practice of the local assessor was to base assessment primarily on acquisition value. Similar taxpayers in West Virginia were, therefore, potentially subject to arbitrary and capricious treatment—this was a violation of "systemic" horizontal equity. The Court was sensitive to these violations in West Virginia, but was willing to allow the substantive horizontal inequities in assessments in California to continue.[12]

---

[10] Wood (2006) illustrates his thesis by discussing Supreme Court jurisprudence in a variety of contexts including interpreting statute of limitations, taxpayers affected by changes in the law, and fairness claims under the Commerce Clause.

[11] See 448 U.S. 336 (1989) and 505 U.S. 1 (1992) respectively.

[12] The Court used the relatively weak "rational basis" test under Equal Protection Clause to justify the distinctions between properties that were embodied in Proposition 13.

II. Conflicts Between Ability to Pay and Benefit Theories of Property Taxation

Proponents of the property tax often praise it under both a benefit theory of taxation and on ability to pay grounds. Yet, there is an inherent conflict between the two approaches and they also fail to some degree on their own terms as well.

As we noted above, theorist in the Tiebout tradition demonstrated how competing communities could decentralize decisions about the scope and size of local government services.[13] The associated efficiency of this view can be seen as an underlying vision of either a plethora of differing gated communities or the un-gated equivalents with zoning or other legal restrictions in effect and services fully confined to the community. Under the pure benefit view, property taxes can, under certain assumptions, be seen as equivalent to lump-sum taxes, not distort housing consumption decisions, and have no distributional consequences. Evidence of capitalization of taxes and services is often used to justify this view. However, Zodrow (2006) provides a useful summary of the difficulties in using capitalization to distinguish between the benefit view of the property tax and what he terms the "capital tax" view in which the excise component of the property tax distorts economic decisions. As Zodrow (2008) also emphasizes, even in models specifically designed to provide long run capitalization results, <u>changes</u> in taxes will only be capitalized in the long run for new purchasers of properties. Upon implementation of a property tax change, however, the changes in land prices for current land owners will not be related to the benefits received.

[13] Again, see Oates (1999) and Zodrow (2006) for discussions.

In practice, the gated community vision can break down on a number of different dimensions. First, the gates may not be porous, zoning and legal restrictions not sufficiently robust, or services not strictly confined to the community in order to sustain the benefit tax view. To the extent that this is true, it weakens connections between taxes and benefits received for particular households within a community. Second, one of the primary goods provided through the local property tax is education. However, the state interest in education typically leads to complex subsidy and redistribution policies across communities that weaken the connection between local taxes and services. The most dramatic of these would be a state-wide property tax that would effectively end the Tiebout sorting. Third, property taxes are also levied on non-homeowner property that can vary substantially across jurisdictions. Commercial and industrial property as well as rental or vacation property falls into this category. The presence of this alternative base of property has important implications in the educational area, where the links between income and property wealth across districts can be tenuous.[14]

As a result of these factors, it is fair to say that there are some connections between taxes paid and services received from the household point of view, but the connections are not perfect or certainly transparent. In particular, that can mean an increase in the market value of property would not translate directly into increased services. To the extent that this occurs, there will be no perceived benefits from higher property taxes under market value taxation.

[14] For a recent discussion of property taxes and education, see Kenyon (2007).

Public opinion surveys support a theory of attitudes towards taxation based on perceived costs and benefits.[15] On the cost side, the public is more likely to believe taxation is too high when tax rates are historically high, are more likely to believe that one tax is the "worst" when rates are high, and, for property taxes, are less likely to view it as the "worst" tax when property tax limits are in place. On the benefit side, perceived linkages between taxes and spending are viewed favorably, explaining the relative popularity of payroll taxes that finance Social Security and Medicare. Individual preferences also seem to accord to their relative position in the income distribution both in terms of taxes paid and benefits received.

Taxpayers overall attitudes towards taxation has implications for the property tax. Whether or not the property tax functions perfectly as a benefit tax in practice, taxpayer attitudes favor the normative principle that it should. Taxpayers expect there to be a link between the taxes they pay and the benefits they receive.

The ability to pay view differs from the benefit view in that it views property taxes as properly falling on higher income individuals. Since the benefit view implies that there is no redistribution—just purchases of services—both cannot be true at the same time. Proponents of the ability to pay view take the position that it functions as a tax with two components. The average property tax rate falls on capital as a whole and, if capital mobility is limited beyond a country's borders, it falls on the owners of capital and is thus progressive. The second component is the differential between the average rate and the local rate which acts as an excise tax. Gravelle (2007) used estimates of effective tax rates across states in the United States to estimate whether the excise taxes

[15] This paragraph draws on the research of Campbell (2008).

had any distributional implications across poor or rich states. In practice, she found that the variance of effective property tax rates across states was relatively low so that the excise effects had minimal distributional consequences.[16]

But even on its own terms, the ability to pay justification for market value property taxation is rather tenuous. There is an inherent ambiguity as to whether ability to pay should apply to current income or some broad measure of wealth. From the property tax revolts, we certainly know that the link between income and property wealth is not terribly tight—property wealth does rise with income but there is considerable variance in any distribution with substantial number of low income households with considerable wealth. What is ability to pay in these circumstances?

But even if the link between income and wealth were close so that this difficulty did not arise, what is the justification for a tax that just falls on property wealth? In the earliest days of the property tax, it was viewed as a form of a wealth tax and did, in some states, fall on financial assets as well as property. But this proved to be unworkable and by the Great Depression, financial assets were removed from its base and, indeed, eventually personal property disappeared as well.[17] Thus, the property tax no longer falls on all forms of wealth, primarily just real property. Clearly this violates any sense of horizontal equity for a wealth tax—two individuals with equal wealth could easily have different allocations of that wealth between real property and all other assets.

---

[16] Her results were robust across different measures for determining effective tax rates for California. See Gravelle (2007).

[17] Vehicle license fees, which are in lieu taxes on personal property, did persist but those came under fire as well in many states, including Virginia and California.

Public opinion research also suggests natural limits on the use of wealth taxes. Americans are strongly ambivalent about taxing the wealthy.[18] While they may support general statements that the rich should pay more, surveys indicate that they oppose confiscatory taxation at high levels of income and, in the past, have strongly supported an upper limit to federal income tax rate at 25 or 35%. In general, support for a policy of income redistribution through the income tax is supported by less than fifty percent of the population. And, when it comes to taxes that clearly target the wealthy, taxpayers are also reluctant to tax them too heavily. Attitudes towards the estate and gift tax are notoriously unfavorable.

Economists have been aware of these issues for some time. They have debated whether the property tax is a benefit tax or a progressive tax on capital. And they understood the weaknesses of each approach. Yet, when pressed to justify market value taxation, they have often offered both views at the same time. More recently, a new strand of thinking has emerged emphasizing the uncertainty of property tax obligations to the taxpayer, which has important implications for fairness.

III. Implications of Uncertainty of Property Tax Shares

Consider a local government collecting a fixed amount of property tax revenue to provide local services, which remain constant. If total assessed values in the community change, the government alters the property tax rate to maintain the same total revenue. Now consider the plight of Homeowner A in the community, when the following events could occur:

---

[18] Campbell (2008), Chapter 6, summarizes a number of the public opinion surveys on taxing the wealthy.

- A new mall opens outside the community reducing the market value (and assessed value) of the mall within the community.
- A raft of foreclosures hit another part of the community with resulting property tax delinquencies and non-payment.
- The EPA discloses that toxic wastes were found in another part of the community, sharply lowering market and assessed values.
- An assessor recalibrates his statistical assessment model and, based on recent sales of cul-de-sac property similar to that of Homeowner A, increases Homeowner A's assessed value more than the average for the community.
- Newly made entrepreneurs move into the neighborhood of our homeowner which has the consequences of increasing the market and assessed value of his property.

What all these events have in common is that the relative share of Homeowner A's assessed value of property in the community has increased. Assuming a single property tax rate and a fixed revenue target, this means that Homeowner A's property tax bill will increase. Anderson (2007) suggests that shifts in relative home prices or between residential and non-residential property may be an important cause of voters' support for property tax limitations.

In Anderson's view, economists know very little about the volatility of individual property tax payments or equivalently the micro-volatility of relative tax shares. Quoting from Adam Smith, he suggests taxpayers are guided by the principle that "*The tax each individual is bound to pay ought to be certain, and not arbitrary….The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very*

considerable degree of inequality, it appears, I believe, from the experience of all nations is not near so great an evil as a very small degree of uncertainty."[19]

Anderson's point is that a rigid adherence to market value taxation ensures that individual tax payments mirror the taxpayer's own share of total market value. That is a uniform and clear standard. But that uniformity and clarity is purchased at the expense of volatility in property tax payments, which are clearly resisted by taxpayers as observers since Adam Smith have duly noted. One taxpayer response to underlying volatility and shifting tax shares is assessment limits. However, these limits do not always produce the precise results that are desired. For example, a homeowner may believe that she benefits from a five percent assessment limit on her property if it appreciated by six percent. But what is relevant in determining her property tax bill is her share of total assessed value, which could actually increase because other more highly appreciated properties are also limited.[20]

The perceived unfairness of shifts in assessed values altering property tax payments may have deep psychological roots. In social psychology there is a research tradition that focuses on "procedural justice."[21] In this tradition, procedures or processes which are perceived to be fair are those in which individuals affected by the decisions have a "voice" in the process. Voice can be effective by giving individuals a chance to alter outcomes and by also providing for opportunities for personal satisfaction from participation in the process or simple expression of their views. Local control of tax

[19] The quotation is taken from Adam Smith, *Wealth of Nations*, Book V, as cited in Anderson (2007), p. 100.

[20] This phenomenon has been documented by the Minnesota Department of Revenue in their *Limited Market Value Report 2007 Assessment Year* (2008).

[21] A comprehensive reference on procedural justice is Lind and Tyler (1988).

property tax rates, with decisions made by local governing boards, can be seen as example of permitting "voice" in the process of determining property tax payments. This is a natural complement to the "exit" alternative highlighted in the Tiebout world.

Now what is striking about the events that could have impacted Homeowner A's relative share of market value was how abstract and distant they were from Homeowner A's immediate universe. The assessor did not pay a visit to Homeowner A and discuss whether the extensive new remodeling in kitchen and porch area constituted new construction. If that had occurred, Homeowner A may have pleaded her case and lost, but at least would have had the opportunity to participate in the process. Instead, Homeowner A may have had her assessment increase because of market forces outside her control, newly uncovered knowledge that is unrelated to her own homestead, or, perhaps worst of all, the vagaries of an impenetrable computer program. In none of these cases did Homeowner A have a chance to participate in any meaningful way in determining her property tax bill. At some level, of course, Homeowner A must recognize (as Marx clearly did in the 19th century) that global market forces can disrupt the economy of everyday life—but somehow, it still seems unfair that property tax bills can change, often dramatically, with potentially no change in actual value of a house or in the services provided by the community.

While global forces that determine property values may seem alien to individual homeowners, these same homeowners are also subject to psychological forces that determine their own perceptions of the values of their homes. Psychological researchers have long noted that individuals view personal belongings as extensions of themselves, value them in that light and, according to "symbolic self-completion theory" can use

them to communicate their identities to others.[22] Moreover, recent research demonstrates that the value individuals place on property also depends on social phenomenon, such as group identity.

In a series of experiments, psychological researchers have illustrated how property values can be influenced by group identity. In one experiment, subjects were first asked to self-identify with a group and were scaled on their group identity—in this case, New York University. They were then subsequently asked to place a value on a pictured townhouse (between $1 million and $15 million) with a prompt that identified the townhouse as part of NYU's history. Estimated valuations of the townhouse were positively correlated with strength of identification to NYU. In a second experiment, subjects were classified into four groups by whether or not the pictured townhouse was tied to NYU's history and whether they had read a positive or negative article about NYU's reputation. Subjects placed a significantly higher value on the property when group identity was threatened and the property was tied to NYU's history. Other experiments confirmed that subjective valuations were influenced by other aspects of group identity.

These finding suggest that homeowners' valuations of their own property may be sensitive to social aspects of their environment that may not be directly correlated to economic phenomenon. For example, an influx of immigrants to a neighborhood could actually have a positive influence on property values, but could be perceived negatively if the influx of immigrants were viewed as a "threat" to the neighborhood. In general, it

[22] These theories are discussed in Ledgerwood et al (2007).

suggests that subjective estimates of market value may be unstable and prone to fluctuations as the social environment changes.

IV. What Might A Fair Property Tax System Look Like?

If the property tax system based on market value is not perceived as fair by taxpayers, is there a possibility of designing a fair system? Based on our review of the factors that may reflect the perceived factors of property taxation, individual homeowners would be more likely to believe a property tax system is fair if the following criteria are met:

- The system embeds some relationship between taxes to services, but no pretense should be made that actual payments are directly tied to actual benefits, particularly at the higher end of the property tax spectrum.
- Property taxes and actual tax rates can vary across communities with differing service packages as long as there is some type of "voice" in place to insure a sense of procedural fairness.
- There should be vertical equity in the design of the system, but this needs to be coupled with a clear recognition that property taxation is not synonymous with wealth taxation.
- Voters revealed preferences strongly suggest that there should be some stability in relative assessments of property values, at least over some period of time. This perhaps reflects both a desire to avoid uncertainty in relative property valuations caused by either external market or global forces or subjective psychological phenomenon.

How do actual property tax systems stack up against these criteria? Stability for homeowners inevitably entails some limits on rates or assessments. How do two of our existing systems of limits fare against these criteria?

California's property tax system after Proposition 13 does reduce uncertainty for homeowners as long as they remain in their homes, limiting increases in assessed values to 2% a year, and thereby reduces uncertainty at the individual level. The reduction in uncertainty, however, comes with stark and documented inequalities at the level of individual homeowners.[23] Neighbors with differing purchase dates for their properties may pay radically different amounts for the same services. While these differences have ameliorated somewhat over time, as some of the properties that initially benefitted in 1978 when the law was passed have been sold, these inequalities have not disappeared.

One can make a life-cycle equity argument for Proposition 13 under the following conditions. Assume that all properties appreciate at the same constant rate and all properties turnover at the same fixed rate. Then, in time as the property tax system adjusts, individuals would all share in the same life time benefits from the assessment provisions of Proposition 13, even though a cross sectional view would apparently show inequalities relative to market value assessments. The extreme assumptions needed to generate this view—constant appreciation rates and fixed turnover intervals—also exhibits its weaknesses.

On other dimensions, Proposition 13 also failed to generate an ideal model of property taxation. The 1% fixed tax rate eliminates local discretion, virtually eliminating

---

[23] These are well documented in O'Sullivan, Sexton, and Sheffrin (1995).

connections between tax payments and benefits. Indeed, the fixed tax rate effectively converts the property tax to a statewide tax and severely curbs local discretion. Other states with assessment limits coupled with tax rate limits fall into this same general category. As we noted, Proposition 13 fails miserably on "snapshot" horizontal equity, as neighbors may pay radically different taxes depending on their length of stay in the residence. Florida has a similar scheme with homestead assessments limited to 3% increases and, unlike California, has recently carried this further by allowing these low assessed values to be carried to new primary residences.

Despite these glaring defects, Proposition 13 remains very popular among California voters. As a report from the Public Policy Institute of California notes:

> *By a large margin (56% to 33%), likely voters (mostly homeowners) believe that Proposition 13 turned out to be a good thing rather than a bad thing for California. Nearly half (49%) are also comfortable with the fact that Proposition 13 (and rising prices) can make recent homebuyers pay higher property taxes than those who purchased a similar home in the same neighborhood several years before.*[24]

In my view, the primary reason that Proposition 13 remains popular is that homeowners have certainty over their property taxes. As long as they remain in their residence, they will not find their lives disrupted by changes in property taxation. If they choose to move, they understood they will most certainly face a new fiscal reality. That, however, is viewed as a "voluntary" action, in the same way that paying a sales tax on a purchase of a new consumer durable can also be seen as a "voluntary" action. And, sales taxes

---

[24] Public Policy Institute of California (1996). The report does indicate that renters (and non-voters) have a harsher view of Proposition 13.

typically score very highly among taxpayers on surveys of fairness. This may be another application of procedural justice theory—taxpayers are effectively given a voice if they choose to move or to purchase a new consumer durable.

Minnesota's Limited Market Value Law embeds some modest assessment limits within a decentralized property tax system that allows for local decisions on rates. Its limits are relatively modest however. Eligible property (farms, residential property, cabins, and timberland) are subject to assessment increases of no more than the maximum of: (a) 15% of the prior year's taxable value or (b) 33% of the difference between the prior year's taxable value and the current market value. Thus, individual property tax bills can increase substantially in any one year (or over several years) even with these limitations. The law is scheduled to expire after taxes payable in 2009.[25] Measured by value, the program affects 3.8% of property in the specified classes, with homestead values only decreased by 1.5%. The Minnesota system does preserve considerable local discretion but at the price of considerable individual taxpayer uncertainty. As it only serves as a temporary brake on an underlying system of market value property taxation, it shares the limitations of the property tax as an ad hoc wealth tax that likely provides relatively little connection between taxes and services at the high end of the property tax distribution.

But let's consider another property tax system. In its ideal form, this one limits taxpayer uncertainty on a year to year basis; it allows local variation in property tax rates to provide voter voice and differential taxation; and has a non-linear structure that may provide a better link between tax payments and services, particularly at the higher end of

[25] See supra (14) for the most recent legislative report.

the distribution. That system is the "council tax" of England, Wales, and Scotland. How does it work?

V. The Council Tax

The council tax was introduced in 1993 as a replacement for the ill-fated community charge or "poll tax." It applies only to residential property. Property taxes on business properties were centralized and removed from local government control in 1990 when the poll tax was introduced. Domestic residences are placed into assessment "bands" based on the assessed value of the property in 1991. Properties constructed after 1993 are assigned an estimated 1991 assessment value. Local councils have the authority to set the rate for the "D" band and other rates are fixed proportions of the rate for the D band. There are discounts for one person and low income households.

Table 1 outlines the structure of the system for England in 2006.[26]

[26] Institute for Fiscal Studies (2006), p. 22.

Table 1: Banded Property Tax System for England, September, 2006

Band	Tax Rate Relative to Band D	Valuation Bands as of April 1, 1991 (pounds)	Distribution of dwellings by band
A	2/3	Up to 40,000	25.2
B	7/9	40,001-52,000	19.3
C	8/9	52,001-68,000	21.6
D	1	68,001-88,000	15.2
E	1 2/9	88,001-120,000	9.5
F	1 5/9	120,001-160,000	5.0
G	1 2/3	160,001-320,000	3.6
H	2	Above 320,000	0.6

In Wales, there was a revaluation of property which took affect in April 2005 based on April 2003 property values and a higher rate of 2.5 was added to the system.

Average D band payments have roughly doubled from 1993-94 to 2006-07 which are £1,268 per year. Local finances have been controversial in the United Kingdom for decades. One of the main difficulties is that the council tax is the only local tax for which there is discretion, yet it provides only a small portion of local revenue. Thus, a one percent increase in desired local expenditure will lead to roughly a four percent increase in the community charge.[27] A number of commissions have been charged with reviewing the system of local taxation in the United Kingdom. The most recent was headed by Sir

[27] See Tony Travers (2007).

Michael Lyons who issued his report in March 2007.[28] Sir Lyons recommended preserving but reforming the system, including revaluating property, adding bands at the top, and removing the option to "cap" council tax increases. The government did not adopt these recommendations.

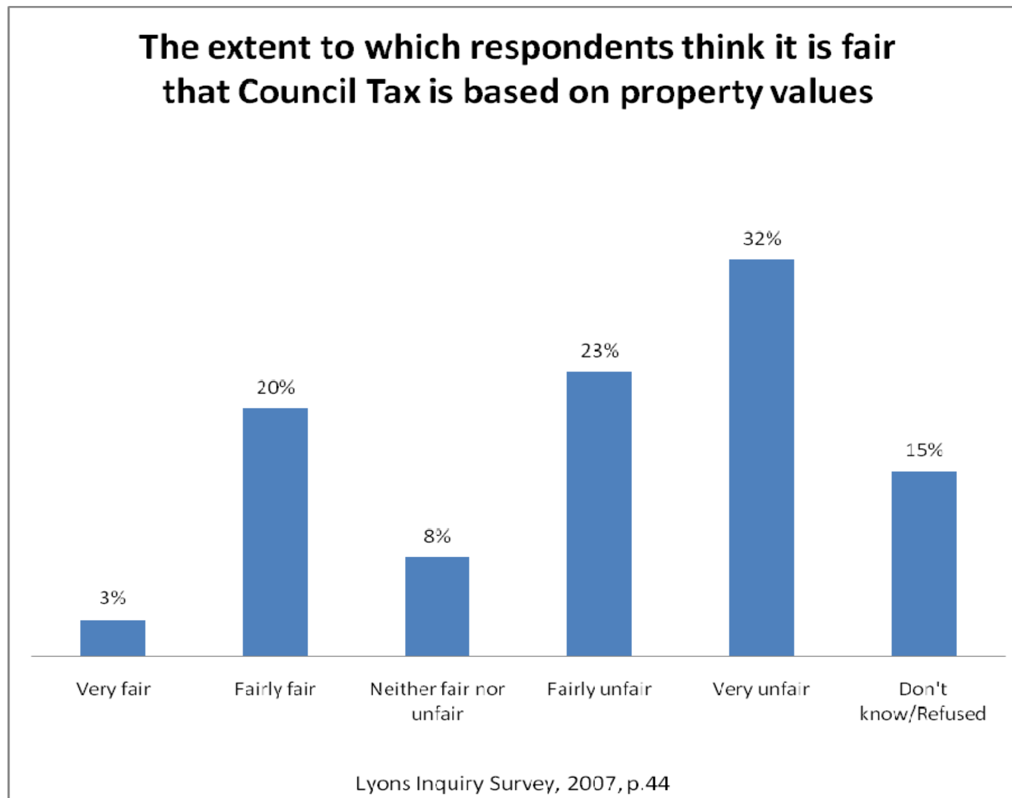
As it is currently structured, the council tax places a limit on council taxes for the most highly valued properties at double the benchmark rate. The highest valued properties pay a rate three times the lowest rate, although residents of the lower valued properties are more likely to receive the "council benefit" or subsidy. The 3:1 ratio was meant to balance two considerations: residents in a jurisdiction share the same local services (although may value them differently) and residents of high valued properties pay more, a tip towards vertical equity. Does this provide the right balance between ability to pay and benefits received?

Somewhat surprisingly, residents of the United Kingdom are not keen on using the council tax for much redistribution. According to surveys undertaken in conjunction with the Lyons report, over 50% of respondents thought it was "fairly unfair" or "very unfair" to base the council tax on property values whereas less than 30% felt it was "fairly fair" or "very fair." Looking at the issue from the point of view of changes in property values, the survey also asked respondents agreement with the idea that if a person's house goes up in value more than others in that area then they should pay more council tax. Approximately 55% felt this was "fairly unfair" or "very unfair" while only

[28] See the Lyons Inquiry into Local Government (2007).

25% felt it was "fairly fair" or "very fair."[29] The survey results from the Lyons Report appear below in the Figures 1 and 2.[30]

Figure 1

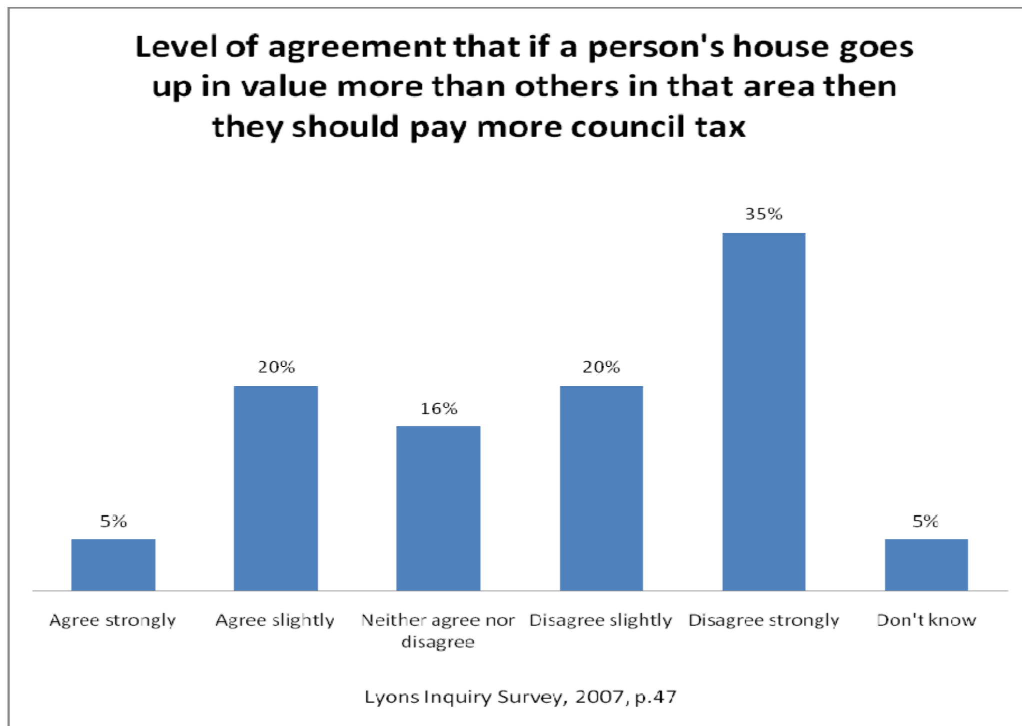


---

29 Lyons Inquiry, supra 20, Chapter 7, p. 226.

30 Lyons Inquiry Survey, BMG Research, pp. 44, 47.

Figure 2



Surveys undertaken for an official review of local government in Scotland found dissatisfaction with the council tax at 60%, only exceeded by the tax on petrol. However, of those respondents, 54% felt it was too expensive while only 31% felt it to be unfair. According to the report, some of the perceived unfairness was due to its alleged impact on low-income households.[31] (This report did recommend replacing the council tax with a conventional property tax system, which the Lyons report dubbed a "point value" tax.)

Academic research in the United Kingdom finds a strong, positive relationship between income and home values at all income ranges except for the lowest income households.[32] As a consequence, the council tax imposes a higher burden on average on

[31] See A Fairer Way (2006).

[32] See Davies, Orton, and Bosworth (2007).

higher income households. Only 6-10% of households with incomes less than 60% of the median income fall into the E-H bands, whereas 51% of households with incomes twice the median fall into those bands.[33] According to the Lyons report, 80% all households in the H range have high income levels (twice median) with the remaining falling into the average income category.[34] As expected, council benefits are also disproportionately allocated to those households in the lower bands.

Why then is the council tax not appreciated more? As we noted, it is the sole local discretionary tax yet provides only a small portion of local revenue, thereby subjecting it to potentially large increases as local budgets increase. It is very visible, particularly in a system in which most of the revenue for the country is garnered through a VAT and through income tax withholding with the government calculating individual tax liabilities. Like all property taxes, "hardship cases" of low income and high property wealth may take mythic proportions, even when the evidence suggests that these are rare. Finally, despite faring reasonably well on ability to pay grounds, a majority of taxpayers seem to believe that taxing households with higher property values is not fair. Perhaps taxpayers do not appreciate the established links between income and property tax values on average or are simply more concerned about variation around this basic pattern. But these sentiments would doom all property taxation and are not confined to banded systems.

---

[33] See Table 1 in Warwick Bulletin (2004).

[34] Lyons, supra (20), Chapter 7, p. 231, Chart 7.6.

VI. Trouble in Paradise?

Previous authors who have championed property tax banding have highlighted its applicability to transitional economies or developing countries with little property or ownership information.[35] The argument in this paper goes further and suggests that a banded property tax with local discretion represents a reasonable compromise between ability to pay and benefits received criteria and also operates as a system which preserves relative stability in relative property tax valuations, thereby eliminating one degree of individual taxpayer uncertainty.

What can go wrong in paradise? One strong hint comes from England's inability to update its valuation bands since they were established in 1993. A revaluation was originally scheduled in England for April 2007 but was postponed while awaiting the Lyons report. After the report was published, the government also declined to undertake a revaluation. There are a number of consequences of using out of date assessments and banding categories. If properties were revalued and the banding categories updated, many individual properties could easily change categories resulting in higher or lower council bills. Since assessment bands are uniform across the country, properties in regions which had more appreciation (Southeast England) would experience an increase in the percentage of properties in the upper bands, thereby changing the distribution of payments within local jurisdictions.

On balance, fairness of the system would be increased with revaluations, but the United Kingdom government sought to avoid the short term disruptions that would accompany a revaluation. Infrequent revaluations are not an unusual phenomenon in

---

[35] See McCluskey et al (2002) for advocacy for this position.

property tax systems, but fifteen years without revaluations is a long time. In principle, there should be fewer difficulties with revaluations in a banded system than an ad valorem system, as the potential exposure to higher council bills is reduced through the banding feature. Is there some inherent feature of a banded system that makes it more difficult for periodic revaluations, or is this a political phenomenon of the United Kingdom?

There is a second, more theoretical issue that highlights a potential weakness in a banded system. If properties are revalued and jump to a higher class, there is a discrete change in tax payments. Compared to an ad valorem system, one could have fewer changes in taxes because of relative valuations, but larger changes when they actually occur. In particular, there will always be properties on the "borders" of the bands that are susceptible to jumping classifications. This phenomenon should be familiar from the "Ss" models of inventory and or price change in macroeconomics. The banding feature itself limits changes in tax liabilities in this case, but they can occur. One could always "smooth" these changes over some period as with assessment limits but that adds another, albeit familiar, complication to the system.

These discrete jumps are another aspect of periodic revaluations that should occur in an ideal banding system. It would be valuable to calibrate a system with periodic valuation on data from other jurisdictions to see what the effects would be on individual property owners. That could potentially help us see whether a system that works plausibly well in theory could also work well in practice.

References

Anderson, Nathan B., 2007, "Property Tax Limitations: How, What, Where and Why," *State Tax Notes*, January 15, 2007, pp. 93-100.

Baldassare, Mark, 2006, "At Issue: California's Exclusive Electorate," Public Policy Institute of California, San Francisco, at http://www.ppic.org/content/pubs/atissue/AI_906MBAI.pdf Accessed March 28, 2008.

Campbell, Andrea Louise, 2008, "How Americans Think About Taxes: Public Opinion and the American Fiscal State,' manuscript in progress, available at http://www.law.nyu.edu/colloquia/taxpolicy/papers/08/Campbell_excerpt_Intro_Ch_1_6_March_2008.pdf Accessed March 28, 2008.

Davies, Rhys, Michael Orton and Derek Bosworth, 2007, "Local taxation and the relationship between incomes and property values," *Environment and Planning C: Government and Public Policy*, vol. 25, pp. 756-72.

Galle, Brian, 2008, "Tax Fairness, unpublished paper available at: http://www.law.nyu.edu/colloquia/taxpolicy/papers/08/Galle_-_Tax_Fairness.pdf Accessed March 28, 2008.

Gravelle, Jennifer, 2007, "Who Pays Property Taxes? A Look a the Excise Tax Effects of Property Taxes across the States, unpublished paper.

Hartley, James E., Steven M. Sheffrin, and J. David Vasche, 1996, "Reform During Crisis: The Transformation of California's Tax System during the Great Depression," Journal of Economic History, September 1996.

Institute for Fiscal Studies, 2006, "A Survey of the UK Tax System," London.

Kenyon, Daphne, 2007, "The Property Tax – School Funding Dilemma," Cambridge, Massachusetts: Lincoln Institute of Land Policy.

Ledgerwood, Alison, Ido Liviatan, and Peter J. Carnevale, 2007, "Group-Identity Completion and the Symbolic Value of Property," Psychological Science, vol.18, no. 10, pp. 873-878.

Lind, E. Allen and Tom R. Tyler, 1988, The Social Psychology of Procedural Justice, New York and London: Plenum Press, 267 pp.

Local Government Finance Review Committee, 2006, A Fairer Way, Edinburgh, http://www.scotland.gov.uk/Publications/2006/11/06105402/0, Accessed March 26, 2008.

Lyons Inquiry Survey, BMG Research, March 2007, http://www.official-documents.gov.uk/document/other/9780119898569/9780119898569.pdf Accessed May 23, 2008.

Lyons, Sir Michael, Lyons Inquiry into Local Government, 2007, http://www.communities.gov.uk/localgovernment/localgovernmentfinance/lyonsinquiryinto/ Accessed March 26, 2008.

McCluskey, William J., Francis A.S. Plimmer, and Owen P. Connellan, "Property Tax Banding: A Solution for Developing Countries," 2002, *Assessment Journal*, March/April, pp. 37-47.

Minnesota Department of Revenue, Tax Research Division, 2008, "Limited Market Value Report, 2007 Assessment Year," http://www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/2008_lmv_final.pdf (March 1, 2008). Accessed March 24, 2008.

Murphy, Liam and Thomas Nagel, 2002, The Myth of Ownership, Oxford and New York: Oxford University Press, 228 pp.

Oates, Wallace, 1999, "Local Property Taxation: As Assessment," Land Lines, Lincoln Institute for Land Policy, vol. 11, Number 3, May.

O'Sullivan, Arthur, Terri Sexton, and Steven Sheffrin, 1995, Property Taxes and Tax Revolts: The Legacy of Proposition 13, New York and Cambridge, Cambridge University Press.

Sheffrin, Steven M., 1994, "Perceptions of Fairness in the Crucible of Tax Policy" in Joel Slemrod, ed., Tax Progressivity and Income Inequality, Cambridge University Press.

Smolka, Martim, and Fernanda Furtado, " Lessons from the Latin American Experience with Value Capture," Land Lines, Lincoln Institute for Land Policy, vol. 13, Number 4, July.

Tax Foundation, 2006, Special Report, "2006 Annual U.S. Survey of Attitudes on Tax and Wealth, No. 141, April, Washington, D.C.: Tax Foundation.

Tax Foundation, 2007, Special Report, "What Does America Think About Taxes? The 2007 Annual U.S. Survey of Attitudes on Tax and Wealth, No. 154, April, Washington, D.C.: Tax Foundation.

Travers, Tony, 2007 “Visible Taxes May Be Good But Make Easy Targets,” *Financial Times*, April 5, p. 15.

Warwick Bulletin, 2004, “Wealth rich but income poor?” Warwick Institute for Employment Research, No. 75, University of Warwick.

Wood, Richard J., 2006, “Supreme Court Jurisprudence of Tax Fairness,” Seton Hall Law Review, Vol. 36, pp. 421-79.

Zodrow, George, 2006, “Who Pays the Property Tax?” Land Lines, Lincoln Institute for Land Policy, vol. 18, Number 2, April.

Zodrow, George, 2008, “Intrajurisdictional Capitalization and the Incidence of the Property Tax,” Rice University, unpublished paper.