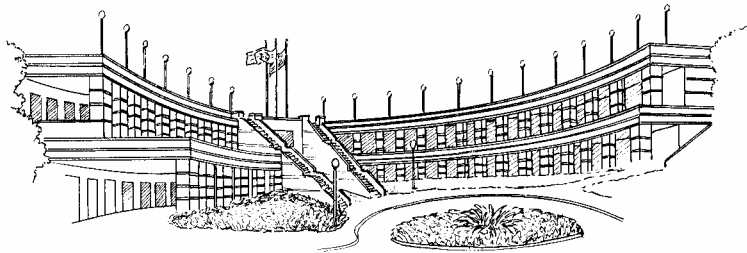


Comments on Property Tax Reform Proposals

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Introduction

The property tax has been in the spotlight for almost two decades now, beginning with Proposition 13 in California, which attacked the growth of the property tax with a sledgehammer, and spreading to other states with various revolts, reforms, restraints and even a few unsuccessful efforts at total repeal. In order to understand what has happened to the property tax, and where it may be headed or perhaps should be headed, we need to look back at the evolution of this very important revenue source over the course of the 20th century.

The golden age of the property tax—if ever it existed—was a century ago. At that time, land and improvements were the primary form of wealth, so the property tax was much closer to being a broad-based tax on wealth than it is today. Agriculture was still the main occupation, and many farmers saw cash only once a year at harvest time when they paid their taxes and stocked their larders.

Then, the property tax revenues collected were used mainly to pay for property-related services, including farm-to-market roads and law enforcement that protected property rights. In many jurisdictions, property tax assessors did not attempt to measure the market value of property, that elusive concept that has brought the property tax so heavily under fire. Instead, assessors relied on various proxies for market value, such as acreage, the number of windows and doors, and the existence of furnaces or indoor plumbing.

Between then and now, two important things happened to the property tax. First, it went from being a state and local tax to being mainly a local tax as states shifted primarily to sales taxes and later to income taxes during the Great Depression. This development took some pressure off the property tax. Even at the local level, the property tax share of total revenue has gradually declined over the decades as local governments increased their dependence on state aid, fees and charges, and local sales taxes. This revenue diversification also took some pressure off the property tax.

But in another role, reliance on the property tax expanded in the 1950s and 1960s as it became a major source of school funding during a period when education spending was growing very rapidly. The demands of the Baby Boomers as they passed through the public schools between 1951 and 1982 forced up property tax rates across the nation, except in those few states like Hawaii that rely almost entirely on state funding for schools.

We need to keep in mind that South Carolina property tax burdens are not high. In 2002, South Carolina's per capita revenues from property taxes were \$772, compared to only \$678 in North Carolina, a bit more in Georgia (\$810) and a U.S. average of \$993. Thus per capita revenues from property taxes in South Carolina were about 80 percent of the national average. South Carolina's personal income is about 83 percent of the U.S. average as well. And then there are states like Massachusetts, where the per capita property tax is a whopping \$1,384.

When governments lean more heavily on a particular tax its flaws become more visible. The property tax is lumpy. It comes to taxpayers in one big bill once a year. Property reassessment

leads to sticker shock when tax bills increase dramatically. And unlike the sales and income taxes, there's no cash necessarily flowing in or out of a piece of property that property owners can use to pay the tax bill (unless it is rental property).

So for all these reasons and more, the property tax is the one tax people love to hate. We can try to get rid of it, which is very hard to do. We can reduce its importance in the revenue system somewhat by substituting other revenues. Or, we can patch up the flaws in the property tax and keep it running for a while longer as an important part of the state and local revenue system.

Underlying issues in property taxation

Before making any fundamental changes in the property tax system, it is important to remind ourselves why we have a property tax and how it fits into the overall revenue system. If state or local governments provide property tax relief, it doesn't end the need to fund schools and local public services. If the state provides property tax relief by funding of a higher share of public education, then the state needs to generate more revenue to cover this expense. If the state provides property tax relief, as it currently does in the form of funding a portion of some people's residential property tax, that relief will also require more state revenue. Property tax relief programs ultimately shift the tax burden to other taxes, fees, and charges.

There seems to be a lot of resistance toward raising the state income tax, so everyone is pointing to the sales tax as the preferred way of raising more state revenue. But the sales tax is vulnerable. South Carolina is already losing a lot of potential revenue because of internet, catalog, and cross-border shopping. Raise the sales tax rate, and that kind of tax avoidance will increase. You can certainly try reducing sales tax exemptions, but that has been proposed frequently in the last decade without much success. Every exemption has a vocal constituency. Expanding the sales tax to services is also going to run into resistance. Florida learned this lesson about 20 years ago when the state tried to broaden the base of its sales tax.

A basic rule of public finance is that it is better to have more taxes and taxes with broader bases at lower rates than to push one tax too hard, drive up the rate, and encourage various strategies for avoiding or reducing that tax burden.

Who bears the tax burden? The hardest challenge in designing and reforming tax systems is to decide how the tax burden should be distributed among individuals and firms. Should it be proportional to something, such as income, spending, or property value? Or should it be progressive, like the income tax? Or should certain kinds of spending or property bear a smaller or larger burden?

Decisions about who is favored by tax breaks are also implicitly decisions about who is *not* favored—those taxpayers who get to bear more of the burden. Are there particular groups that need to be protected from the tax burden for some reason other than income? Why do we as a state favor homeowners so strongly over other groups? Why is spending on tangible goods taxed, but not spending on services? Why do senior citizens get so many tax breaks relative to younger families?

South Carolina's property tax system favors homeowners, owners of large tracts of undeveloped or agricultural and forested property, new and expanding industry, and old people. That implies that we as a state choose to shift a larger share of the property tax burden to renters, commercial property, established industry, and younger families. Is that what we intend to do?

Pros and cons of property taxation. Property taxes do have some positive attributes. Most economists believe that the burden for paying for shared public services should be apportioned among taxpayers in proportion to their ability to pay.

How do we measure ability to pay? There are three broad measures: income, spending, and wealth or assets. For income, we use the income tax. For spending, we use the sales tax. For wealth, we use the property tax. It is possible to avoid paying your share of the cost of public services on one or even two of these measures, but not all three. So using three tax “handles” instead of just one or two ensures that the burden is broadly distributed among the population but remains tied to measures of ability to pay. The property tax is actually not a bad proxy for wealth. For most families, their home and other real property is their biggest asset.

A second criterion used by economists for how to distribute the burden of paying for public services is the benefit principle. Those who benefit more from public services should pay a larger share than those who don’t. Many city and county services are services to property—trash pickup, street lights, street maintenance, police and fire protection. The property tax is as good a way as any to pay for those services. Paying property taxes for local services is not all that different from paying Duke Power for electricity or Bell South for your telephone. The value of fire and police protection is greater for an expensive home than a more modest one, just as the cost of fire insurance is higher on the more expensive home. The value of protective or esthetic services—green space, zoning, landscaping—is also greater for higher-valued property.

Public education is a shared responsibility and also a shared benefit. Everyone in the community gains when there are more educated consumers, citizens, and workers. Because more of the benefits accrue to the local area than the rest of the state, locals should contribute to creating those benefits. Good schools also enhance property values.

The drawbacks of the property tax are well known:

- Insufficient cash flow in many cases with which to pay taxes that are billed only once a year.
- The problems of assessing property accurately and the sticker shock associated with reassessment.
- Perceptions of unfairness in distribution of the burden, which are intensified in a classified assessment system like the one we have in South Carolina and a minority of other states.

Are these drawbacks big enough to call for elimination of the property tax? Probably not. Certainly no other state has succeeded in eliminating the property tax, although many have tried and have had some success in shifting part of the tax burden away from the property taxes and toward other revenue sources, mainly sales taxes.

Assessment issues

Many of the property tax reform proposals under consideration in South Carolina involve real property assessment in one way or another. Assessment caps, targeted relief, and revaluing property only at the time of transfer are all assessment-related issues. One of the assessment issues that has not received recent consideration is rethinking the current classified assessment system.

Assessment classes. South Carolina is one of only seventeen states that do not assess property at a uniform percentage of market value. The state’s property tax system has become simpler with the reduced assessment rate on personal vehicles but still contains multiple classes and is

designed to favor homeowners and agricultural and forest land and other undeveloped property at the expense of rental, commercial, industrial, and personal property owners.

The use and abuse of the farm and forest classification is well known and worth revisiting because it shifts the tax burden to all other classes of property. Well-crafted legislation that supports green space and habitat preservation as well as legitimate farm and forest activities can address this distributional issue. If the state tightens up on abuse in this category, it can insist that any increase in revenue from that source be dedicated to property tax relief for the remaining categories of property in the first five years so that other property owners receive tangible evidence of the redistribution of the tax burden.

Combining the reduction in assessment on cars with the various kinds of authorized property tax relief for new and expanding business firms suggests that South Carolina is moving in the direction of a simpler assessment classification system with just two rates instead of four: 4 percent for large new industries, homeowners, and agricultural property, and 6 percent for everything else. Perhaps this change should be an explicit goal for the state. There are some significant transitional revenue costs of making such a shift, but the long-run benefits of a simpler and more transparent property tax classification system are worth exploring.

But there are lessons to be learned from the reduction in the assessment rate on cars that hit local governments, including school districts, very unequally. Even with the reduction transitioned in over six years, the average reduction in the tax base was over 8 percent, higher in some areas than in others. Some of the increase in tax burdens on residential and commercial property that people are complaining about can be traced to the loss of revenue from personal vehicles, a loss that was not compensated by the state.

Sticker shock. Sticker shock is probably the largest single problem with the property tax in South Carolina because reassessment is infrequent. Annual reassessment would reduce the sticker shock, but it's expensive.

The property tax relief from the General Assembly in the last decade has actually increased the sticker shock effect of reassessment for owner-occupied property. Consider what just happened to my house in Pickens County's recent reassessment. I saw a one-third increase in its assessed value, which is probably accurate. But my property tax bill will likely increase by 75 percent if tax rates don't change.

My house went from about \$150,000 to \$200,000 in market value at reassessment. If the mill rate for schools is 200 and 100 for the county and city combined, my previous tax bill would have been \$800 (local option sales tax credits ignored in this example). I would only have been taxed on \$50,000 in assessed value for school mills (\$400) because of school property tax relief and on only \$100,000 in assessed value for city and county mills (\$400) because my husband is over 65 and gets a \$50,000 homestead exemption. But after reassessment, that extra \$50,000 in assessed value means an additional \$400 in school taxes unless the school mill rate goes down. Then there is another \$200 in city and county taxes on that extra \$50,000, so our tax bill may now rise \$600 to \$1,400 from \$800 in the previous year. In trying to help homeowners and especially elderly homeowners, the General Assembly made their sticker shock at reassessment worse. Only part of the value of their home is taxable but all of the increase in value is taxable once that home is worth at least \$100,000.

Assessment caps. Assessment caps are not a particularly appropriate response to the problem of sticker shock. Assessment caps merely shift the burden of paying for public services from rapidly

appreciating property to slowly appreciating property. A cap is likely to mean a shift in the tax burden from higher-income to lower-income households and from residential to commercial property, including rental property as well as retail and service firms that are an important source of jobs and income in South Carolina.

Assessment at time of transfer. The idea that property be reassessed only when it is transferred came from California, part of Proposition 13 in 1978. If property is only reassessed when it is sold, transferred, or inherited, there will be a market valuation as a guide to assessment. What has happened in California is that two identical properties, sitting side by side, bear very different tax burdens depending on whether one has been sold recently and the other hasn't. That's really unfair. The two houses consume the same amount of local government services, have the same obligation to support the schools, but the taxes they pay depend not on the actual value of their property or on their income and ability to pay but on how recently the property was bought, sold or inherited.

Distributional issues

As a general principle, any kind of tax relief should be targeted to those who need it. If heir property needs relief, give it to heir property. If renters need relief, give it to renters. Elderly people are now less likely to be poor than younger families, in addition to which they get a lot of income tax relief in this state that younger families don't. Not all elderly people are on fixed incomes—most are not. And not all elderly people are homeowners. Some rent, and get none of that property tax relief.

Property tax relief that is based on income is preferable to relief that is based on categories that don't relate to ability to pay taxes, such as being old or owning rather than renting. Many states have addressed distributional issues by establishing specific distributional goals that relate to fairness in distribution of the burden as well as providing incentives for the use of property in ways that promote economic development. South Carolina has addressed this second goal but not the first.

Property tax "circuit breakers" of various kinds offer an alternative way to provide tax relief to those who need it in order to stay in their homes. Circuit breakers aren't just based on income but on the property tax bill in relation to income. There are a number of ways of designing circuit breakers, any one of which would improve the equity or fairness of the South Carolina property tax. Because renters pay property taxes in their rent, circuit breakers should include renters. Groups that already receive property tax relief (homestead exemption, school property tax relief) should qualify for either their existing relief or a circuit breaker, but not both.

Rental property is a big distributional issue. In areas where rental property is scarce relative to demand, the property tax will be passed on to the renter. Renters don't get to deduct the property tax on their income tax, unlike homeowners, but they are still bearing the burden in the form of higher rent. In areas where there is a glut of rental property (not common in South Carolina), the owner may have to absorb some of the property tax. How much of the burden falls on the owner and how much on the tenant is a matter of some dispute, but in general most of it is passed on to the renter, especially in the long run as rental markets adjust. Renters not only do not get the tax deduction, they are also living in property that is assessed at a 50 percent higher rate than owner-occupied property and do not qualify for any of the tax relief provided to homeowners. In favoring owner-occupied property, the General Assembly has discriminated in significant ways against both owners and tenants in rental property.

Replacement revenue sources

Almost all of the proposals to replace part or all of the revenue lost in changing or eliminating the property tax would rely on shifting the burden to the sales tax. No consideration has been given to the income tax as a possible source of additional revenue either by adjusting rates or by eliminating exemptions or deductions. If all issues are on the table in terms of property tax relief, then the income tax and changes thereto should also be considered.

Sales tax rates, base, and exemptions

There are two ways to raise more revenue from the sales tax. One is to raise the rate. The other is to expand the base by eliminating existing exemptions and expanding from just tangible goods to include at least some services. Both methods have advantages and drawbacks. South Carolina's sales tax rate is low by national standards, even with the local option sales tax in 29 of the 46 counties. The rate could be increased somewhat without disadvantaging in-state retailers, although the sales tax is regressive and this change would shift more of the tax burden to lower-income households.

Eliminating exemptions has been proposed many times but has proven difficult to enact because of the resistance of entrenched beneficiaries of such exemptions. Finally, expanding to include services is rather attractive in making the sales tax less regressive while raising more revenue. However, service providers are generally smaller firms than retailers of tangible goods, so the cost of collection will be higher for the state and the cost of compliance will be higher relative to the value of sales for the firms.

The sales tax is vulnerable to expansion of internet and catalog sales. If South Carolina is going to rely more heavily on this tax, it would be desirable to actively work with the Multistate Tax Commission and others in creating a more uniform state tax base and urging Congress to lift the current ban on state taxation of internet sales and purchases.

Education funding

The issue of education funding is tied to any property tax reform because a significant share of the present funding for public education comes from the property tax. If the state were to take over the entire cost of education, there would have to be a significant expansion of state revenues. But there is another issue as well. There is a link between schools and property values, and also between local contribution and local sense of ownership and control of schools. Good schools enhance property values. Parents buy homes in better school districts and are willing to pay higher property taxes to ensure that they stay good. Even non-parents know that the value of their property when they buy or sell is directly connected through the property tax to the quality of the local schools. In California, breaking the link between property taxes and schools has reduced overall support for education.

Conclusion

Property tax reform and relief has been a constant challenge to South Carolina in the last 15 years. Any reform or relief will have ripple effects throughout the state and local revenue and expenditure systems. Legislators must be careful to address both efficiency issues of incentives to work, to create jobs and wealth, and to locate or remain in the state; and equity issues of fair distribution of not just the property tax burden but the overall burden.

These hearings have brought legislators in touch with many citizens, but the interests and concerns of those not at the table must also be taken into account. State and local government needs a strong, diversified, dependable revenue system to provide the infrastructure and public services that South Carolina needs in order to grow and prosper in the 21st century. The property tax will, in some form, continue to be a vital part of that revenue system.