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# THE PROPERTY TAX IN THE 1980s AND PROSPECTS FOR THE 1990s

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## ABSTRACT

In the late seventies, the secular decline in reliance on property taxation was expected to continue through this decade. However, the decline of the property tax has slowed, perhaps even halted. Reasons for this are examined and it is found that changes in the growth and allocation of fiscal responsibility did affect the property tax as anticipated, but that other trends did not continue. The implications of federal income tax reform for the property tax is also examined. Although property taxation has become a more expensive way to fund local expenditures, other factors, especially the relative price increase of sales taxation, are likely to soften the impact of tax reform. Finally, possible structural changes in the property tax resulting from tax reform are discussed.

## INTRODUCTION

There has been a longstanding downward trend in the importance of the property tax as a financing source of state and local governments. The property tax declined from 56.7 percent of state and local tax revenue in 1940 to 29.9 percent in 1987. By 1987 it had fallen to 3.3 percent of personal income from 4.2 percent two decades earlier and, in real terms, the per



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TABLE 1

Property Tax Trends

| | 1967 | 1977 | 1979 | 1981 | 1983 | 1985 | 1987 |
|---|---|---|---|---|---|---|---|
| Property tax as pctg of personal income | 4.2% | 4.1% | 3.2% | 3.0% | 3.1% | 3.1% | 3.3% |
| Property tax as pctg of state and local taxes | 42.9% | 35.6% | 31.6% | 30.7% | 31.4% | 29.7% | 29.9% |
| Property tax per capita (current dollars) | 132.15 | 289.16 | 294.98 | 325.65 | 380.91 | 433.83 | 497.09 |
| Property tax per capita (1982 constant dollars) | 367.67 | 429.80 | 375.45 | 346.58 | 366.75 | 391.02 | 422.45 |
| Effective property tax rate for single family dwellings with FHA insured mortgages | 1.70% | 1.67% | 1.56%(a) | 1.26% | 1.31% | 1.21% | 1.15% |

For sources, see data appendix.
(a) 1978 data.

capita amount paid was lower than it was a decade ago. The past few years, however, have seen something of a revival of the property tax. Between 1981 and 1987 property tax revenues increased substantially in real per capita terms and as a percentage of personal income. Furthermore, the decline in property tax revenues as a proportion of state and local tax revenue has slowed greatly (Table 1). The effective property tax rate has been decreasing by a slower rate during the eighties than it did in the previous five years, although this pattern was heavily influenced by Proposition 13.(1)

In the early eighties, some analysts believed that the downward trend in the relative importance in the property tax would continue. A number of reasons were

cited.(2) First, the rate of growth of the state and local government sector was expected to slow, due to a reduction in the demand for education services, the lingering effects of the tax revolt of the late 1970s, and continued reduction in federal aid and its stimulative effects. Second, regional shifts in the growth of population and economic activity favored the sunbelt states, which have traditionally made less use of the property tax as a funding mechanism. Third, there was a secular trend toward the centralization of revenues and expenditures to the state government level and Reagan federalism was expected to accentuate this shifting of financing responsibility to state sales and income taxes. Fourth, the slower growth in housing demand due to slower population growth and the shift from physical goods production to the production of services (and thus to lower land and physical capital requirements) was expected to slow the growth in the value of taxable property. Underlying all of this was the basic distaste for property taxation on the part of voters.(3) A fifth major influence on the property tax that few analysts anticipated at the beginning of the decade was the change in the federal income tax code.

There were also reasons to expect an increased reliance on the property tax. These include the federal tax incentives to real estate investment in the early 1980s, lower interest rates, and the reductions in federal aid that would force state and local governments to rely more on their own resources. Finally, to the extent that property tax assessment practices have improved in the 1980s, reliance on property taxation would be increased.

In this paper, our question is whether the property tax is on the upswing as a state and local government revenue source or whether it will decline in

importance in the 1990s? Part of the answer lies in gaining a better understanding of the determinants of its revenue performance in the 1980s and part lies in assessing the impact of the new economic and political environment of the late 1980s and 1990s.

## AN EMPIRICAL EXPLANATION

One approach to explaining the aggregate patterns of property tax revenue change described in Table 1 is to look for patterns in the data. In the straightforward empirical description here, we ask whether the changing reliance on the property tax may be traced to (a) the changing rate of growth in state and local government budgets, (b) shifts in population and fiscal activity to regions where the property tax is less used, (c) centralization of fiscal activity to the state government level, and (d) the underlying growth in real estate investment.

### Slower Growth in the State and Local Government Sector

The first hypothesis is that the state and local government sector as a whole grew more slowly in the 1980s than in the previous decade and, consequently, the property tax has grown more slowly. In fact, the growth in state and local government revenue (either inclusive or exclusive of federal aid) did slow in the late 1970s and early 1980s (Table 2). Beginning in 1983, however,the trend was reversed and expenditure growth has actually exceeded that experienced in the late 1960s. This reversal has contributed to the observed growth pattern of the property tax in the 1980s.

### Regional Shifts

As may be seen in Table 3, there are significant regional differences in the extent to which state and

## TABLE 2

### Trends in the State and Local Government Sector

| | 1967 | 1977 | 1979 | 1981 | 1983 | 1985 | 1987 |
|---|---|---|---|---|---|---|---|
| CONSTANT 1982 DOLLARS PER CAPITA: | | | | | | | |
| General Revenues | 1280 | 1956 | 1979 | 1953 | 1998 | 2250 | 2389 |
| Own Source Revenues | 1064 | 1532 | 1549 | 1540 | 1631 | 1853 | 1991 |
| Federal Aid | 216 | 423 | 430 | 414 | 367 | 397 | 398 |
| Property Tax | 368 | 430 | 375 | 347 | 367 | 391 | 422 |
| Total Expenditures | 1481 | 1872 | 2200 | 2247 | 2324 | 2477 | 2699 |
| Local General Revenue | 818 | 1220 | 1218 | 1182 | 1221 | 1328 | 1424 |
| Local Expenditures | 934 | 1158 | 1339 | 1326 | 1369 | 1465 | 1608 |
| PERCENTAGE: | | | | | | | |
| Local tax revenues to total | 47.9% | 42.5% | 39.2% | 38.8% | 39.8% | 38.4% | 39.1% |
| Local expenditures to total | 63.1% | 61.9% | 60.8% | 59.0% | 58.9% | 59.2% | 59.6 |

For sources, see data appendix.

## TABLE 3

### Regional Variations in Sources of State and Local Revenue, 1987

| | Percentage of Total Revenue | | | | Per Capita |
|---|---|---|---|---|---|
| | Property Tax | Income Tax | Sales Tax | Federal Aid | Federal Aid |
| New England | 20.2 | 17.3 | 10.3 | 14.6 | 504 |
| Middle Atlantic | 15.7 | 17.8 | 9.7 | 13.6 | 565 |
| Great Lakes | 16.3 | 13.6 | 10.9 | 13.8 | 454 |
| Northern Tier | 16.5 | 16.1 | 10.3 | 13.8 | 509 |
| South Atlantic | 13.2 | 10.5 | 12.8 | 12.6 | 366 |
| South Central | 7.3 | 7.8 | 14.2 | 17.2 | 479 |
| Southwest | 15.9 | 2.9 | 12.8 | 11.9 | 351 |
| Southern Tier | 12.4 | 7.3 | 13.2 | 13.7 | 394 |
| Plains | 14.8 | 11.9 | 11.0 | 13.6 | 440 |
| Rocky Mountains | 14.7 | 9.9 | 10.2 | 14.3 | 489 |
| Far West | 11.1 | 14.0 | 9.9 | 11.3 | 453 |
| Western Tier (a) | 12.3 | 12.7 | 10.1 | 12.1 | 459 |
| United States | 14.1 | 12.6 | 11.1 | 13.3 | 457 |

For sources, see data appendix.
(a) Includes Alaska and Hawaii.

local governments are dependent on tax revenues in general and the property tax in particular. The second hypothesis is that economic and population growth is concentrated more heavily in the "sunbelt" states in the 1980s, and since these states are more fiscally centralized and generally have smaller per capita state and local expenditures, property tax revenues have grown more slowly. The trend of the 1970s did continue into the 1980s with southern and western states growing four times as fast as northern states (Table 4). In 1967, 29.9 percent of the U.S. population resided in the south. By 1980, that had increased to 33.3 percent and by 1987 to 34.2 percent.

We can explore the importance of regional shifts on the use of the property tax by multiplying actual per capita property tax revenues in 1987 by the 1977 distribution of population, by state. This gives us an estimate of the amount of property tax revenue that would have been collected had there been no shifts in population among states and no change in intensity of use of the property tax. From this calculation we estimate that property tax revenue would have been only $1.3 billion (1.0 percent) greater than actual 1987 collections if the shift in population had not occurred during the 1977-1987 period. We cannot conclude, then, that population movements significantly dampened property tax growth in the 1980s.

This small regional effect may be explained by the partial elimination of the regional differences in the intensity of use of the property tax. Between 1977 and 1982 real per capita property tax revenue fell by 2.7 percent per year in the north but fell by only 1.3 percent in the south. Between 1982 and 1987 real per capita property tax revenue grew by 3.1 percent per year in the north but by 5.6 percent in the south.

TABLE 4

Regional Shifts in Populations, Income, Property Tax and Total SLG Expenditures (a)

| | 1967 | 1977 | 1982 | 1987 | Average Annual Change 1967-77 | 1977-82 | 1982-87 |
|---|---|---|---|---|---|---|---|
| Northern Tier | | | | | | | |
| Population | 92,457 | 95,088 | 95,757 | 97,356 | 0.3% | 0.1% | 0.3% |
| Income | 9,585 | 10,976 | 11,581 | 13,921 | 1.4% | 1.1% | 3.7% |
| Property Tax | 412 | 502 | 447 | 518 | 2.0% | -2.3% | 3.0% |
| SLG Expenditures | 1,479 | 2,002 | 2,360 | 2,841 | 3.0% | 3.3% | 3.7% |
| Southern Tier | | | | | | | |
| Population | 59,252 | 67,891 | 77,168 | 82,970 | 1.4% | 2.6% | 1.4% |
| Income | 7,046 | 9,307 | 10,067 | 11,227 | 2.8% | 1.6% | 2.2% |
| Property Tax | 209 | 250 | 237 | 304 | 1.8% | -1.1% | 5.0% |
| SLG Expenditures | 1,216 | 1,551 | 1,883 | 2,317 | 2.4% | 3.9% | 4.2% |
| Western Tier | | | | | | | |
| Population | 46,436 | 52,709 | 58,235 | 62,449 | 1.3% | 2.0% | 1.4% |
| Income | 9,202 | 11,003 | 11,690 | 13,404 | 1.8% | 1.2% | 2.7% |
| Property Tax | 480 | 530 | 352 | 430 | 1.0% | -8.2% | 4.0% |
| SLG Expenditures | 1,821 | 2,050 | 2,545 | 2,983 | 1.2% | 4.3% | 3.2% |
| United States | | | | | | | |
| Population | 198,145 | 215,688 | 231,160 | 242,775 | 0.8% | 1.4% | 1.0% |
| Income | 8,736 | 10,457 | 11,103 | 12,867 | 1.8% | 1.2% | 2.9% |
| Property Tax | 368 | 430 | 353 | 422 | 1.6% | -3.9% | 3.6% |
| SLG Expenditures | 1,481 | 1,872 | 2,248 | 2,699 | 2.3% | 3.7% | 3.7% |

For sources, see data appendix.
(a) Population in thousands; income, property tax and SLG expenditures are weighted averages in per capita constant (1982) dollars.

## Centralization

If the financing of state and local government services did continue to shift to the state government level in the 1980s as it did in the 1970s, then reliance would continue to shift from property tax to sales and income tax. The fiscal centralization thesis is examined by considering local tax revenues and expenditures as a percentage of the totals for state and local governments. Table 2 provides evidence that the trend toward centralization in the state government level substantially flattened in about 1981. In 1967, 47.9 percent of total state and local tax revenues were

raised locally. By 1981 this had decreased to 38.8 percent and has remained essentially at that level through 1987. Local expenditures tell the same story. Thus the anticipated correspondence between centralization and property tax reliance is observed, although the trend did not continue as expected.

Housing Demand and Construction Activity

Construction activity and increases in real estate prices largely determine the growth in the property tax base. The fourth hypothesis is that construction, both housing and commercial, slowed due to the slower population growth and shift in production from goods to services. These major demographic and economic trends will be evident in the long-term, but over short time periods, the state of the economy dominates. As the recession deepened between 1977 and 1982, total construction, measured in constant dollars, fell by 2.5 percent per year. Over the next five years, it rebounded, growing at the rate of 6.4 percent per year.(4) (During the former period, there was significant positive growth in commercial construction.) These data are inconsistent with the hypothesis of slower growth in construction activity during the 1980s. However, the parallel shifts in construction activity and property tax reliance was as anticipated.

## THE FEDERAL TAX CODE

The late 1980s brought federal tax reform and a very significant change in the setting in which property tax decisions are made. These changes in the tax code fall into two categories: changes that affect the "price" of all state and local expenditures, both absolutely and in relative terms amongst tax

instruments, and changes that influence consumption and investment behavior and hence the size and growth of the property tax base.

Tax Prices

A lowering of marginal tax rates has been an important part of the tax reform story of the 1980s. The 1981 Economic Recovery Tax Act (ERTA) began the process of lowering marginal federal income tax rates by dropping the top rate from 70 percent to 50 percent. This change reduced the value of deductions for state and local taxes paid for high income itemizers, thus raising the effective price of a dollar of expenditure. This process was continued by the 1986 Tax Reform Act (TRA), which lowered the top tax rate from 50 percent to 33 percent. As a result of the 1986 change, the marginal rate for the average itemizer is expected to decline from a 1985 rate of 25.6 percent to about 25 percent. In addition, the standard deduction was raised from $2,480 to $3,000 (for single taxpayers) and the AGI threshold for itemized deductions was increased from 5 percent to 7.5 percent for medical deductions and imposed (at 2 percent) for other deductions. It is expected that this will reduce the percentage of taxpayers that itemize from 41.1 percent in 1985 to about 26 percent.(5)

The TRA also eliminated the deductibility of sales tax payments. Deductibility of state and local taxes has been a feature of our federal income tax system since its inception in 1913, with only minor changes: the elimination of deductibility of license fees and some excise taxes in 1964 and the elimination of deductibility of gasoline taxes in 1978. However, during the eighties, both academic and legislative support for this concept of allowing deduction of taxes

was waning. As part of the 1982 tax act, Congress considered but rejected eliminating the deductibility of all state and local taxes, and in his 1984 budget, President Reagan proposed the same thing.(6) In the end, the compromise result in 1986 was to eliminate only the deduction of sales taxes.

These changes differentially reduce the value of deductibility of state and local government taxes and reduce the number of people who claim these deductions. Their combined effect is to increase the tax price of state and local expenditures, i.e., the net price that residents must pay for each dollar of expenditure. The cost of raising revenue from sales tax increased more than from property and income taxes because of the elimination of deductibility of sales tax payments.

What do we expect this increase in tax price to mean for the growth in property tax revenue in the next decade? In theory this should slow the growth in expenditures, and thus the property tax. Whether this actually happens, however, depends on the price elasticity of demand for local public services, the extent to which the property tax is paid by individuals who itemize, and whether the relative price increase of the sales tax will stimulate property tax collections.

Because there is no commonly accepted theory to explain how individual preferences are aggregated into public decisions, it is difficult to estimate the separate effects on local budgets, and therefore property taxes, of changes in community income, general environmental factors, and tax prices. A voluminous literature on this subject shows that the estimates of these elasticities, and the interpretation that is placed on these estimates, depends on the underlying model to which one subscribes.(7) There is no firm consensus from this research, but the more recent work

points toward a higher price elasticity than was previously thought. Feldstein and Metcalf's estimates of the community price elasticity, for example, range from -2.99 to -5.99, depending on the model specification.(8) Other recent work has produced similar results. There is less empirical evidence, however, to guide us in predicting what will happen when the relative prices of different tax instruments change.(9)

In order to examine the possible magnitude of these effects, we first estimate the changes in the tax price of each instrument. The tax price (P) refers to the after tax cost to taxpayers of each dollar of state and local tax burden that they bear.(10) The tax price may be expressed, in general, as

$$P = (1 - it),$$

where i is the itemization variable and t is the marginal tax rate. For our purposes, we will consider the community tax price; thus i represents the proportion of taxpayers in a jurisdiction who itemize and t is the (average) marginal federal tax rate faced in the community.

The effects of the new federal tax code on the tax price are exerted through two channels. The first is the decline in marginal tax rates (25.6 percent for itemizers in 1985 to approximately 25 percent under the 1986 Tax Reform Act) and the decrease in the percentage of taxpayers who itemize (41.1 percent in 1985 to approximately 26 percent). The second is the elimination of sales tax deductibility. These changes yield an increase in the price of the property tax and income tax of .040, from .895 to .935; and an increase in the price of the sales tax of .105, from .895 to 1.00.(11)

Given these price changes and some estimate of the price elasticity (E), we can then estimate the change in any particular state and local government tax revenue ($\Delta T$) due to the change in the tax price ($\Delta P$) as

$$\Delta T = E(\Delta P/P)T.$$

Since we lack evidence on the effects of differential changes in prices, such an estimate may be thought of as a rough approximation of the pressure to adjust tax-financed expenditures. Using a price elasticity of -3.0 for all three instruments yields a decrease in the desired level of expenditures of 12.8 percent, 12.8 percent and 31.4 percent, financed by the property tax, income tax and sales tax, respectively. At 1987 levels, this is a desired decrease of $15.4, $12.3 and $33.2 million in tax revenues collected from the property tax, income tax and sales tax, respectively; in total this represents 7.9 percent of all state and local expenditures in 1987.

Tax Base

The 1980s have seen a seesaw of changes in the federal tax code which have implications for the growth in the property tax base. These include changes in tax depreciation schedules, capital gains rates, and the treatment of passive losses. The ERTA began the process by halving real property's depreciable life from 30 to 15 years and by lowering the effective capital gains rate for the marginal investor from 25 percent to 18 percent.(12) These changes provided an enormously favorable environment for investment in property development. The result was an increase in real estate construction, especially in the commercial sector. This should have stimulated property tax collections as the increased value of newly developed property was captured in the tax base, an effect

consistent with the observed flattening of the decline in property tax collections.

Things begin to change after 1984 when the depreciable life was increased to 18, then 19, and finally 27.5 years; and 175 percent declining balance replaced straight line depreciation. With the TRA, the preferential treatment of capital gains was eliminated and new restrictions on the applicability of passive losses to offset ordinary income were applied.(13)

These changes should tend to reduce the value of the non-residential property tax base. The decrease in marginal tax rates reduces the value of the mortgage interest and property tax deductions, hence increases the cost of owner-occupied housing, and therefore tends to dampen investment in new housing. The combined effect of these changes should be to slow the growth in the property tax base. This implies that the elasticity of the property tax base will decline as investment is shifted to other assets and overall investment is reduced. However, this tendency may be moderated by a decline in real interest rates that some analysts have predicted will occur as a result of the TRA.(14)

Income Effects

If lower federal tax rates mean more disposable income, the TRA may have another, stimulative effect. Congressional estimates indicate that the combined effect of all of the federal changes will result in $41 billion, or about 10 percent, increase in disposable personal income.(15) Because part of the federal tax reduction was absorbed in effective increases in state and local taxes ($17.4 billion), and part was shifted to business taxes that increased personal tax burdens, we estimate the net effect to be close to a 5 percent

increase in personal income. We assume that both the property tax base and the demand for property tax-financed local services have positive income elasticities; however, there is no recent evidence as to their magnitudes. Gramlich and Rubinfeld's survey suggests that 0.6 is representative of the evidence from expenditure studies conducted in the early eighties.(16) Using this elasticity yields an estimated 3 percent increase in the level of property taxation. Thus, the income effect is not expected to be very large.

## PROSPECTS FOR THE 1990s

How will state and local governments react to the new policy environment set by the federal tax code? Are there natural forces in motion that will lead to a continued revival in the property tax over the next decade or will the 1990s hold a continued slide in the importance of the property tax? In this concluding section we address the prospects for regional variations in the intensity of use of the property tax, the direction in which capitalization will effect the property tax rate, the implications of the new setting for property tax relief, and changes in the structure of the tax.

### Regional Variations

In general, the changing federal tax code will have a uniform effect on state and local government finances. Since the price of all tax-financed revenue has increased, we expect to see a decline in the growth of expenditures, greater interstate competition for federal aid and a shift toward non-tax sources of revenue, e.g., user fees and lotteries. Another possible scenario in some communities will be to raise

the effective property tax rate on businesses. Since all of a business's state and local taxes are deductible, the tax price increase will not be as large as for households. Additionally, local voters in many jurisdictions do not perceive that they bear the cost of a tax increase on business. In a study of school expenditures in Boston in 1970, Ladd found that voters acted as if only 21 percent of commercial and 55 percent of industrial property taxes created a local burden.(17) State industrial policy, however, will constrain this approach.

The extent that states will alter their use of tax instruments may vary in response to their current use of these sources, which likely reflects preferences, the extent to which the tax price has changed, and the income and price elasticities of demand for state and local government public services.

Southern states place least reliance on the property tax and exhibit a generally lower preference for public services (Table 3). These states probably have the smallest change in the property tax price because incomes, and thus marginal tax rates, are lower and the number of itemizers is fewer. Those states which place greatest reliance on the property tax -- higher income states -- will probably face the greatest increase in the tax price and the greatest dampening effect on state and local government expenditures.

## Capitalization

It is well accepted that interjurisdictional property tax differentials are capitalized into property values.(18) Hamilton has argued that, given sufficient jurisdictions and mobility, this effect will be exactly offset by the capitalization of benefits from local services demanded by taxpayers in each

jurisdiction.(19) In other words, at equilibrium, the net present value of the benefits less tax burden is, in the aggregate, zero. This implies that there is a perceived link between taxes paid and local services received.(20)

If this is a reasonable approximation of the real world, then the reduction in marginal rates and number of itemizers could have a significant effect on property values. The negative capitalization of the property tax obligation will increase relative to the positive capitalization of the benefits of local expenditures. Furthermore, the loss in value for property owners in low-tax jurisdictions will be smaller than those in high-tax jurisdictions.(21)

The reduction in corporate marginal rates from 46 percent to 34 percent will increase the value of a property tax differential by 12 percent. To the extent that business location decisions, at least for some sectors, are influenced by effective tax rates, the change in marginal rates should increase the movement from high tax to low tax jurisdictions. Although they find no significant correlation between effective corporate tax rate and firm location decisions in general, Wasylenko and McGuire report a significant response by firms in wholesale trade, retail trade and finance sectors to differentials in the effective personal income tax rate.(22)

Tax Relief

The political climate of the eighties, at least at the federal level, has led to a reduction in enthusiasm for income redistribution. Coupled with the fiscal realities facing state and local governments as the tax price of state and local expenditures is perceived to increase and federal aid is further reduced, we might

expect to see a reduction in low income relief programs.

These relief programs take three forms: circuit-breakers, usually state financed; homestead exemptions or credits, some of which are state financed; and deferral programs. In 1988, 32 states had circuit-breaker programs, financed by the state governments through income tax credits, direct rebates or reimbursement to local governments. They are generally targeted towards lower income households although some have further limitations on eligibility, such as age, veteran status or disability. The average benefits in these programs in 1988 ranged from less than $50 to over $500.(23)

Of the 42 states that had homestead exemptions in 1988, in only 17 did the state government fund the program or reimburse the local governments for the lost revenues. These programs are considerably more varied than the circuit-breakers. Only ten states have income ceilings and many states have different relief provisions for different categories of households.

Of the sixteen states that have deferral programs, thirteen are limited to senior citizens, eleven have income ceilings and only six are financed by the state government. In the states that offer such programs, the level of participation is low; therefore the aggregate impact of these programs is inconsequential.(24)

As can be seen from Table 5, there has been little change in the overall pattern of relief programs in the past decade. However, during the higher inflation periods, relief did not keep pace with inflation, falling by 1.1 percent per year in real terms between 1977 and 1984, but it did remain a stable percentage of tax revenues. Between 1984 and 1988, relief outpaced

TABLE 5

Aggregate Property Tax Relief Provisions

| | 1977 | 1984 | 1988 |
|---|---|---|---|
| Number of states with homestead exemptions (a) | 30 | 47 | 42 |
| Number of states with state-financed circuit breakers | 30 | 30 | 32 |
| Number of states raising income ceilings on either | | 32 | 15 |
| Circuit breaker statistics | | | |
| Percentage of population obtaining benefits | 2.4% | 2.2% | 2.2% |
| Current dollar cost ($ million) | 939 | 1,392 | 1,746 |
| Constant dollar cost ($ million, 1982 base) | 1,396 | 1,292 | 1,437 |
| Cost as percentage of property tax revenues | 1.5% | 1.6% | 1.4% |

For sources, see data appendix.
(a) The data do not clearly distinguish between the two types of relief programs in 1977; it is likely that this is an understatement of the actual number of states with homestead exemptions in 1977.

inflation, but did not keep up with the increases in property tax revenues. The story here is that, particularly in the latter period, many state legislatures failed to enact any increase in the income ceilings that determine eligibility.(25) This may be explained by a reluctance to engage in public debate over an effective increase in taxes for poorer households.

Is it likely that property tax relief programs will be extended beyond direct relief to the poor in

the next decade? The federal Tax Reform Act of 1986 places a bias against such actions. If the provision of a relief program reduces the property tax base and therefore must be made up with a higher average rate on the remainder of the base, then there will be more resistance than before because of the increased cost of raising local revenue.

Changes in Definition of the Property Tax Base(26)

The principle of uniformity is central to efficiency and to most concepts of equity in taxation. However, a consistent trend seen in the structure of the property tax over most of this century is towards nonuniformity in definition of the tax base. We do not mean here interstate variations, although that is a by-product; what we mean is nonuniformity in the treatment, within a taxing jurisdiction, of various property, depending on type, use, and characteristics of the owner or occupier. Rather than the uniform ad valorem tax that it may be commonly thought of as, property taxation is now essentially an agglomeration of specific taxes. It has been suggested that this is an artifact of a historical cycle. Lynn describes its as, "[movement] from a specific tax to an ad valorem rate; from taxation of land to tax coverage of all or most property. Thereafter, as property becomes more heterogeneous in character and ownership distributed less equally, other taxes are substituted...and the property tax reverts to a levy essentially on realty."(27)

We have seen the gradual exclusion of personal property from the tax base. From 1956 through 1981, locally assessed tangible personal property decreased from 17.2 percent to 9.6 percent of gross assessed value.(28) The number of states taxing commercial and

industrial personal property declined between 1976 and 1981 from 47 to 43; the number taxing agricultural property declined from 41 to 34; the number taxing business inventories declined from 43 to 28; and the number taxing household personal property declined from 18 to 8.(29)

The trend is equally pervasive with respect to the treatment of real property. The most significant artifact of this trend has been the proliferation over the last decade of de jure real property classification schemes. These have included extensions of the agricultural "actual-use" model to other types of realty and liberalization of relief programs in terms of eligibility for specific populations: elderly, disabled, and veterans. That these classifications have in many cases given formal, legal status to preexisting de facto differentials lends weight to Lynn's observations about a historical cycle. The classification schemes range from the two-tier scheme brought about in California by Proposition 13 to Minnesota's thirty-four or so different classes or rates. Some of these schemes include local-option classification, providing finer distinctions.

There is no reason to suspect that this trend will not continue. Such changes are intended to increase the progressivity, and thus the income elasticity of the property tax. However, by narrowing the tax base, they provide further opportunities for tax avoidance behavior which could have the opposite effect.

## CONCLUSION

Mark Twain would read all of this as saying that reports of the demise of the property tax have been exaggerated. Unquestionably, the property tax suffered during the relatively high inflation of the late

seventies and early eighties. We have seen the effect of the recession and the inability of the assessment process to capture inflation-induced nominal increases in property value. The downward trend in the relative importance of the property tax, apparent over the last two decades, was steepest between 1977 and 1982.

Yet, there is evidence of a flattening of the trend, if not a rebound. Between 1981 and 1987, the property tax increased as a percent of personal income, reversing a trend in the prior fourteen years. Despite continuously diminishing federal aid, local government budgets have grown, although slowly, and the property tax share of these budgets has remained nearly constant between 1982 and 1987.

At the beginning of the 1980s, it was expected that the importance of the property tax would continue to decline as a result of underlying structural changes. However, some of these changes did not occur, while the impact of others was small. Furthermore, the federal tax changes of the 1980s were unforeseen.

It is not clear whether the recent (1986) changes to the federal tax code will work for or against further erosion of the property tax. The cost of the property tax has increased less than the cost of the sales tax and that might cause a shift towards property taxation. But the price of all tax-financed expenditures has increased which could cause a slowdown in the growth of the state and local government sector and/or a shift towards non-tax sources such as user charges. One might also expect to see some recession in the growth of the base as a result of the removal of property investment incentives.

All in all, one might speculate that the state and local governments will move into the nineties with the decline of the property tax in remission, if not halted

altogether. It will not return to its former importance, but the property tax will remain a significant feature state and local finance.

## ENDNOTES

1. If we omit California from the computation, real per capita property tax revenues decreased by 8.0 percent between 1977 and 1983, and increased by 13.1 percent between 1983 and 1987; as compared to -15.9 percent and 14.1 percent, respectively, with California included.

2. See, for example: Bahl, Roy, "Property Taxation in the 1980's" Property Tax Paper Series number TPR-2, The Lincoln Institute Tax Policy Roundtable. Lincoln Institute of Land Policy, Cambridge, MA, 1979.

3. In the July 1988 survey of public attitudes toward taxes, the ACIR found that 28 percent of the public felt that the property tax was the worst tax. This was a decline, however, from 33 percent reported in 1981 and 45 percent in 1972. Advisory Commission on Intergovernmental Relations. Changing Public Attitudes on Governments and Taxes. U.S. Government Printing Office, Washington D.C., 1988.

4. Source: 1989 Economic Report of the President, Table B-52.

5. Estimates for post-TRA marginal rates and percentage of itemizers are from: Courant, Paul N. and Rubinfeld, Daniel R., "Tax Reform: Implications for the State-Local Sector," Journal of Economic Perspectives. 1, no.1 (Summer 1987): 87-100.

6. Treasury I concluded that, since there were no significant national spillover effects of state and local governmental services, these deductions only served to interject the federal government into the fiscal decisions of state and local governments, with capricious effects. See McLure, Charles E. and Zodrow, George R., "Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform," The Journal of Economic Perspectives. 1, no. 1 (Summer 1987): 37-58.

7. The competing theories may be grouped into two basic paradigms. The median-voter model assumes that the quantity of a public good provided reflects the constraints and preferences of the median voter and requires determining the tax price for the median voter. This requires establishing the median voter's marginal tax rate and itemizing status. The dominant party model assumes that bureaucrats weigh the preferences of the entire community, avoiding the problem of identifying the tax price of the median voter and permitting the use of average tax prices.

8. Feldstein and Metcalf use the dominant party approach and argue that we should expect price elasticity estimates to exceed those based on individual tax prices, because the change in an individual's tax price will produce only a small change in the community's tax price. Thus any elasticity computed with respect to the community's price will exceed one computed with respect to the individual's. Feldstein, Martin S. and Metcalf, Gilbert E., "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," Journal of Political Economy, 95, no. 4 (August 1987): 710-736.

9. Several recent studies have failed to find significant correlation between the tax price and relative use of alternative tax instruments. See Feldstein and Metcalf, op. cit., and Holtz-Eakin, Douglas and Rosen, Harvey S., "Tax Deductibility and Municipal Budget Structure," and Lindsey, Lawrence B., "Federal Deductibility of State and Local Taxes: A Test of Public Choice by Representative Government," in Fiscal Federalism: Quantitative Studies, Harvey S. Rosen, ed. The University of Chicago Press in association with the National Bureau of Economic Research, Chicago, IL, 1988.

10. Although not considered explicitly here, the price of the property tax is also reduced by the extent to which actual payments are reduced by either credits against state income tax liability (circuit-breakers and some homestead exemptions) and deductions from state-taxable income.

11. In 1985, $P=1-(.411)*(.256)=.895$ for both sales and property tax. After the TRA, $i=0$ for the sales tax, so $P=1$, while $P=1-(.26)*(.25)=.935$ for the property tax. These calculations compare closely with Zimmerman, Dennis, "Federal Tax Reform and State Use of the Sales Tax," in 1986 Proceedings if the Seventy-Ninth Annual Conference on Taxation, Stanley J. Bowers ed. National Tax Association-Tax Institute of America, Columbus, OH, 1987.

12. Follain, James R., Hendershott, Patric H. and Ling, David C., "Understanding the Real Estate Provisions of Tax Reform: Motivation and Impact," National Tax Journal. 60, no. 3 (September, 1987): 363-372.

13. Follain, Hendershott and Ling provide a convincing argument that the series of changes have had the effect maintaining a roughly constant value of the tax savings per dollar of investment and of the capital gains tax on inflationary gains, in the face of a non-indexed tax system. This analysis suggests that, given the inflation prevailing in 1986, the TRA was an overreaction and predicts a lowering of the capital gains rate and a shortening of the depreciable life, should inflation rebound. Follain, Hendershott and Ling, op. cit.

14. Hendershott, Patric H., Follain, James R. and Ling, David C. "Effects on Real Estate," in Tax Reform & The U.S. Economy, Joseph Pechman, ed. Washington, D.C: The Brookings Institute, 1987.

15. Joint Committee on Taxation. Conference Report, September, 1986: II, 885.

16. Gramlich, Edward M. and Rubinfeld, Daniel L. "Micro Estimates of Public Spending Demand Functions and Tests of the Tiebout and Median-Voter Hypotheses," Journal of Political Economy. 90, no. 3 (June 1982): 535-560.

17. Ladd, Helen F. "Local Education Expenditures, Fiscal Capacity and the Composition of the Property Tax Base," National Tax Journal 31 (March 1978): 145-58.

18. The implementation of California's Proposition 13 provided a natural experiment to test the interjurisdictional capitalization hypothesis. For example, see Rosen, Kenneth T., "The Impact of Proposition 13 on House Prices in Northern California: A Test of the Interjurisdictional Capitalization Hypothesis," Journal of Political Economy. 90, no. 1 (February 1982): 191-200.

19. Hamilton, Bruce. "Capitalization of Intrajurisdictional Differences in Local Tax Prices," American Economic Review 66, (December, 1976): 743-53.

20. Here we abstract from the original research which dealt only with local education expenditures. Additionally, this work did not consider deductibility of property tax payments and thus overstated the capitalization of the tax burdens.

21. Consider two high income communities, one in which the effective property tax rate is 3 percent; the other, 1.5 percent. If the average marginal rate falls from 40 percent to 25 percent under TRA, a home valued at $200,000 in the first jurisdiction will lose $900 in the value of the deduction, whereas a home with the same pre-TRA value in the second jurisdiction will lose $450 in value. At an interest rate of 10%, the present value of theses losses are $9000 and $4500, which would be the reduction in house value if there were complete capitalization.

22. Wasylenko, Michael and McGuire, Therese. "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," National Tax Journal. 38, no. 4 (December, 1985): 497-512.

23. A representative example is Illinois' program. All homeowners and renters 65 years old or disabled, whose annual income does not exceed $14,000, are eligible. The relief, in the form of a rebate from the state, is based on the amount by which the property tax (or 30 percent of the rent) exceeds 3.5 percent of household income, plus a fixed grant of $80. The maximum relief is $700 less 4.5 percent of household income. In 1988, the number of beneficiaries and average benefit was 374,000 and $254, respectively.

24. Gold, Steven D. "State Tax Relief for the Poor: An Overview," unpublished manuscript, (December, 1986), p. 23.

25. Only Maine has automatic indexation of its program ceilings.

26. This discussion follows Bowman, John H., "Recent Changes in Property Taxation and their Implications for Balance in State and Local Revenue Systems," The Quest for Balance in State-Local Revenue Structures. Lincoln Institute for Land Policy, Cambridge, MA, 1987.

27. Lynn, Arthur, D. "Property Tax Development: Selected Historical Perspectives," in R.W. Lindholm, ed., Property Taxation - USA TRED-2, University of Wisconsin Press, Madison, WI, 1967: p. 16.

28. Bowman, op. cit., p. 85.

29. Bowman, op. cit., p. 86.

## DATA APPENDIX

The data used in the preparation of this paper were obtained from the following sources.

State and local revenues, by source, by level of government and by state: U.S. Bureau of the Census; Government Finances in 1966-67,...in 1976-77, ...in 1978-79, ...in 1980-81, ...in 1982-82, ...in 1984-85, ... in 1986-87; tables 17, 5, 5, 5, 5, 29 and 29, respectively.

State and local expenditures, by level of government and by state: U.S. Bureau of the Census; Government Finances in 1966-67, ...in 1976-77, ...in 1978-79, ...1980-81, ...in 1982-82, ...1984-85, ...in 1986-87; tables 18, 13, 12, 13, 13, 29 and 29, respectively.

State populations: U.S. Bureau of the Census; Government Finances in 1966-67, ...in 1976-77, ...in 1978-79, ...in 1980-81, ...in 1982-82, ...in 1984-85, ...in 1986-87, tables 26, 27, 27, 28, 27, 35 and 35, respectively.

State personal income: U.S. Bureau of Economic Analysis, Survey of Current Business; July 1968, August 1987 and July 1988 issues, pages 10, 44 and 135, respectively.

Average effective property tax rates: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism; 1978-79 edition, table 36 and 1989 edition, volume I, table 33.

Property tax relief programs: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism; 1976-77 edition, volume II, tables 73 and 74; 1978-79 edition, table 44; 1984 edition, tables 71 and 72; and 1989 edition, volume I, tables 35 and 36.