LIMITATIONS ON INCREASES IN PROPERTY TAX ASSESSED VALUE

There have been many efforts made across the country to reform property tax administration, and to impose various limits on the property tax, including limits on the tax rate, limits on the increase in the property taxes levy, limits on what is taxed, and limits on increases in the assessed value of property. The latter is the subject of this brief.

A limitation on increases in assessed values has obvious appeal to property tax payers. While the individual property tax payer sees that the increase in the assessed value is controlled, it is important to consider the broader implications of a assessment limitation.

Existing Assessment Limitations

Seven states have adopted a statewide limitation on the annual growth of property tax assessment. In six states the limitation applies to individual parcels, while in one state (Iowa) the limit applies to the total property tax base. California adopted a property tax assessment limitation as part of Proposition 13, which was passed by referendum in June 1978. California’s limitation is the most widely cited, largely because of the breadth of the provisions contained in Proposition 13 and because it applies to all types of property, not just homesteaded property. California limits annual increases in assessed value to 2 percent.

Some of the limitations are very simple. For example, Florida’s assessment limitation, which only applies to homesteaded properties, restricts increases in assessment to the lower of 3 percent and the change in the Consumer Price Index. On the other hand, Arizona, which adopted an assessment increase limit in 1980, has a more complicated limitation. The system works as follows. Each parcel of property has two separate values, a fair market value (FMV) and a Limited Property Value (LPV). The statutory annual growth limit for the LPV is the greater of 10 percent, and 25 percent of the difference between last year’s LPV and this year’s FMV.

Effect of Limitations on Property Taxes

By themselves, limitations on increases in assessments will not necessarily control the growth in property taxes. Property taxes are the product of the property tax rate and the taxable value, and the assessment increase limitation only affects the taxable value. Local governments can simply raise the property tax rate in order to increase property tax revenue. Consistent with this, Preston and Ichniowski (1991) found that rate limits coupled with caps on assessments were the most effective in limiting municipal property tax revenue, and found that the effect was significant, up to a 45 percent reduction in the growth of property taxes. Shadbegian (1998) found that TELs reduce property taxes per capita by about three percent, while in another paper Shadbegian (1999) found that TELs that are binding reduce property taxes per capita by 12 percent.
Much of the criticism surrounding the property tax and most of the focus on property tax reform is associated with the premise that identical properties, i.e., properties with the same market value, should be assessed at the same value but frequently are not. Acquisition value is based on the premise that properties with the same historic purchase price should be assessed at the same value. (Neither system necessarily results in a close link between assessed value and income, which is another basis for equal treatment.) Given that the property tax is a tax on wealth, fair market value should be the basis for equal treatment. Thus, we focus on the disparities in the ratio of assessed value to market value that arise as a result of acquisition value assessment.

The Assessment Limitation in California

There is little research that addresses the issue of who benefits and who loses from a property tax assessment freeze, and the studies we identified focus on California’s Proposition 13. O’Sullivan, Sexton, and Sheffrin (1995) and Sheffrin and Sexton (1998) provide the most significant analysis of the economic implications of the adoption of acquisition-value assessment in California. The following discussion is based on those studies.

Acquisition-value assessment leads to property tax disparities. To illustrate, consider two identical houses each worth $100,000 in 1975. Assume that the value of each property increases by 10 percent per year (so that market value is $984,973 in 1999) and that one of the houses sold in 1997 for its market value. The assessed value of the house that didn’t sell is $160,843 (the result of the 2 percent annual increase allowed under Proposition 13), while the assessed value of the house that sold is $984,973 (which is the market value in 1999). Thus, the owners of identical houses pay substantially different property taxes; for this example, the owner of the newly purchased house pays 6.12 times more than the other individual. This ratio is referred to as the "disparity ratio."

The level of disparity depends upon the increase in property value, the frequency with which property ownership turns over, and the rate of new construction. For example, if property values increased at 6 percent instead of 10 percent, the disparity ratio in the above example would be only 2.51; if all property sold every year, there would be no disparity.

O’Sullivan, et. al. (1995) calculated the actual level of disparity in 1991 for homeowners for nine counties in California: three urban counties, three fast-growing suburban counties, and three rural and ex-urban counties, while Sheffrin and Sexton (1998) provide updated calculation for Los Angeles county for 1996. 33.2 percent of homeowners paid taxes in 1996 based on the 1975 assessed value increased by up 2 percent per year, while 3.9 percent of homeowners purchased their homes in 1996 and therefore paid 1996 taxes based on the 1996 market value. For the homeowners who have not moved since 1975, the median ratio of actual property value to assessed value is 3.84. In other words, the person who purchased his home in 1996 would pay 3.84 times the property taxes paid by a person with a home of equivalent value that they have occupied since 1975. For the homeowners who have not moved since 1985, the median ratio of actual property value to assessed value is 1.22.

The disparity ratios differ across the nine counties, and at least for Los Angeles county, have fallen since 1991. In general, disparity in the assessed value across homeowners is greatest in urban counties, followed by fast-growing suburban counties, and least for rural counties. This ordering is related to differences in the increase in housing values and turnover rates across the three classes of counties.

For Los Angeles county the ratio of assessed value to market value in 1996 was 0.51, which means that total market value is almost 2 times the total assessed value. Thus, on average, property taxes are 51 percent of what they would be if the limitation on assessment growth and the one percent limit on the property tax rate were not in effect. Several studies have shown that other taxes and fees have increased to offset the reduced property taxes.

O’Sullivan et. al. also find that older and lower-income homeowners have benefitted more from the limitation since these individuals are less likely to move. They also find that the acquisition value assessment has reduced the likelihood that a home owner will move, i.e., it has discouraged home owners from selling their existing home and buying another one. The estimated effect on mobility, however, is small.

The Assessment Freeze in Muskogee County

Beginning in 1983, as a result of a local constitutional amendment, the assessed values of homesteaded property, i.e., property eligible for a homestead exemption, for local property tax purposes were frozen in Muskogee county. The assessed value of such property can be increased only if the property ownership changes (other than between spouses), there is an addition to or renova-
tion of the property, or to correct an error. Thus, for homesteaded property, Muscogee county has a true acquisition value property tax system.

The limitation on assessment increases applies only to local property taxes. Thus, the county must maintain two assessed values, the "frozen value" for local taxes and the fair market value for state taxes, for each homesteaded property. By comparing these two values, it is possible to determine how the freeze has affected property taxes in Muscogee county.

The reduction in the local gross property tax base due to the freeze is not very large; in recent years the difference between that state and local gross digest equals about one year of growth in the state digest. For 1997, the ratio of assessed value for local purposes to assessed value for state purposes is 0.94. This is much smaller than the ratio reported for California; the difference is likely due to slower increases in property values in Muscogee county and perhaps to more rapid turnover of homes.

There are substantial disparities in assessment due to the freeze. While 42.8 percent of parcels with assessed values that exceed the local homestead exemption of $13,500 have ratios of local to state values between 0.9 and 1.0, the remaining approximately 60 percent of parcels have local to state value ratios that range from 0.10 to 0.89, with the bulk lying between 0.50 and 0.89.

Of the parcels that have frozen values in 1997, 28.7 percent were first frozen in 1985 or earlier (data was not available for 1984). For parcels that were first frozen in 1985 or 1984, the disparity ratio is 1.67, or somewhat less than for Los Angeles County. For Los Angeles county, property that has been frozen since 1982, i.e., the same elapse time as the Muscogee freeze has been in effect, has a disparity ratio of 1.27. This is lower than for Muscogee county, reflecting the decline in property values in California during the 1990s. The disparity ratio for Muscogee county decreases the shorter the time the parcel has been frozen, but the change since 1989 is very small.

There are large differences for 1997 between the state (non-frozen) assessed value and the local (frozen) assessed value by assessed value categories. For example, for parcels whose state assessed value is between $200,000 and $300,000 the reduction is 11.2 times the reduction for properties with a state assessed value of less than $25,000. However, expressed as a percentage reduction in assessed value, the relatively larger reductions occur for the low and high valued residential units.

We did not have information on the characteristics of the owner, but we were able to relate the average dollar reduction in assessed value within a census tract due to the freeze increases with the median income, average age, and percent white within the census tract. We find that the elimination of the freeze would increase assessed values more for higher income homeowners, for the elderly, and for whites.

We also explored the effect of the freeze on the probability that a homeowner would move. We expected that the probability of moving should be negatively related to the absolute difference between the state and local assessed value. In other words, we expect that the benefit of the freeze would lock-in homeowners, thereby reducing the probability of moving. Our regression analysis suggests that the probability of moving is unrelated to the value of the freeze.

Summary

Property tax assessment limitations result in some reduction in property taxes. But they create large disparities among taxpayers. It does not appear that such limitations have much effect on the probability that a homeowner will move.

References


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