Rethinking local government reliance on the property tax

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A B S T R A C T

Historically, local governments in the United States have relied on the property tax as one of their main sources of own-source revenues. However, the recent collapse of housing prices and the resulting negative impact on local government budgets suggest that it may be opportune to rethink this strategy. In this paper we document the overall decline in property values in the United States in recent years, and we find that the impact is in the aggregate negative but that the impact varies significantly by state and by locality. We also examine the impact on local government revenues, and we again find substantial regional and local variation. Indeed, our data indicate that substantial numbers of local governments seem to have avoided the significant and negative budgetary impacts seen most clearly for state and federal governments, at least to date. We then focus specifically on the State of Georgia, in order to determine the ways in which local governments have responded to the economic recession. Our empirical analyses indicate that there are several factors causing changes in property tax revenues, but the dominant factor is changes in housing prices, with some significant lags. We conclude that local government reliance on the property tax has in fact been an advantage for many local governments in the current economic environment, and that such reliance is likely to continue in at least some form for the immediate future.

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1. Introduction

There is little doubt that the “Great Recession” that lasted officially from December 2007 to June 2009 continues to have major effects on the fiscal position of federal and state governments. At the federal level, the deficit grew from $459 billion in FY 2008 to $1.4 trillion in FY 2009, which at that time was the largest dollar magnitude in history and also the largest as a percentage of GDP since the end of World War II; even with economic recovery, the federal deficit was $1.3 trillion in FY 2010 and $1.6 trillion in FY 2011, and the current Administration budget proposal projects a FY 2012 deficit at $1.1 trillion, with high deficits projected for the next decade (Office of Management and Budget, 2012). At the state level, the recession has caused the steepest decline in state tax revenues in memory (Boyd and Dadayan, 2009; Boyd, 2010; Mikesell and Mullins, 2010), and states have responded mainly by making major cuts in spending (The Nelson A. Rockefeller Institute of Government, 2010; Center on Budget and Policy Priorities, 2010). Despite these cuts, state budget deficits for the current and immediately future years remain at alarmingly high levels.

How have local governments been affected? It is widely perceived that local governments have also been severely affected by these same forces. The bursting of the housing bubble and the resulting decline in economic activity should, it is believed, have a serious negative impact on local governments, especially those dependent on local property taxes as a major source of revenues. It is this issue that we examine here. We first use data from the U.S. Census Bureau to examine the trends of local government revenues (especially the property tax) over the last decade. We find that there is great diversity in the experiences of local governments over this period and especially in the immediate past several years. However, we also find that the widespread expectation that most local governments have suffered the same fate as state and federal governments is not generally supported, at least to date. We then focus more specifically on the State of Georgia by examining detailed information on property tax assessments and property tax rates for local school districts in the state. We find that property values declined in Georgia (as in many other parts of the country), but we also find that local school districts were in many cases able to maintain a steady pattern of collections by increasing millage rates. Our empirical analyses indicate that there are
several factors causing changes in property tax revenues, but the dominant factor is changes in housing prices, with some significant lags. We conclude that local government reliance on the property tax rather than more elastic revenues sources like income, sales, and excise taxes may in fact have been a significant advantage for local governments in the current economic situation.

2. Housing prices and local government revenues

Local governments in the United States typically rely on several main sources of own-source revenues, including individual income taxes, general sales taxes, specific excise taxes, fees, and charges, and local property taxes. Of these, the dominant source is by far the property tax. In 2008, local property taxes accounted for roughly three-fourths of total local government tax revenues and for nearly one-half of total local own-source revenues (including fees and charges).1

The Great Recession has obviously had serious and negative effects on the level of economic activity, and these effects have in turn depressed revenues of most governments that are reliant upon taxes whose bases vary closely with economic activity, like income and sales taxes. However, an important feature of the property tax is that its base (e.g., assessed value) does not automatically change over time. With the property tax, any increase in the market value of housing does not necessarily translate into an increase in assessed value, and so into an increase in revenues, in the absence of a formal and deliberate change in assessment. Lags in these re-assessments, combined with caps on the amount by which assessed values can be changed in any given year and with deliberate changes in millage rates, mean that changes in the overall level of economic activity that may affect housing values may not actually affect property tax revenues in any immediate or obvious way, unlike other taxes that are much more closely linked to economic activity.2

More generally, there are several channels by which changes in housing values driven by changes in economic activity may affect local government tax revenues (Anderson, 2010; Lutz et al., 2011—this issue). The most obvious is of course via the property tax, although this link is (as noted) neither immediate nor automatic. Other channels are more closely linked to economic activity. Real estate transfer taxes depend upon the volume and the value of real estate transactions, although these taxes are of relatively little importance. Less direct link is (as noted) neither immediate nor automatic. Other channels are more closely linked to economic activity. Real estate transfer taxes depend upon the volume and the value of real estate transactions, although these taxes are of relatively little importance. Less direct channels include those affected by declines in housing values. For example, a decline in housing values may depress new housing construction, thereby reducing sales tax revenues generated by the materials used in construction. The decline in home construction and the resulting fall in employment may also reduce income taxes. Finally, a decline in housing values may reduce consumer expenditures (and so sales tax revenues) via wealth effects.3

As a general framework in which these channels might be modeled, consider a simple setting. Suppose a local jurisdiction has multiple tax sources, each generating revenues defined as the product of a tax rate and a tax base. Denoting each with a subscript $i$, total revenues $R$ equal $R = \sum_i t_i B_i$. Suppose now that either the tax rate or the tax base of each tax changes. Then the percentage change in tax revenues equals:

$$\Delta R / R = \sum_i s_i [\Delta B_i / B_i + \Delta t_i / t_i];$$

that is, the percentage change in tax revenues equals the share $s_i$ of each tax in total revenues times the sum of the percentage change in the tax base plus the percentage change in the tax rate for each of the $i$ taxes. A tax that has a small share of total revenues obviously has a smaller impact on changes in revenues, even if its base and/or rate change significantly; conversely, a tax (like the local property tax) that is a major source of revenues can have a large impact on revenues even if its base and/or rate change by small amounts. Suppose finally that the tax base of each tax is some function of the level of economic activity, denoted $Y$. With a change in the level of economic activity, the percentage change in any tax base due to a changed economic environment can be written as $\Delta B_i / B_i = e_i (\Delta Y / Y)$, where $e_i$ is the elasticity of tax base $i$ with respect to the level of economic activity. The percentage change in total revenues now becomes:

$$\Delta R / R = \sum_i s_i [e_i (\Delta Y / Y) + \Delta t_i / t_i],$$

where $\Delta B_i / B_i$ now represents the deliberative administrative or policy change in the tax base of tax $i$, $\Delta t_i / t_i$ represents the administrative change in tax rate $i$, and $e_i (\Delta Y / Y)$ denotes the (automatic) change in the tax base of tax $i$ stemming from its link with economic activity. This equation summarizes the various channels by which revenues — whether of a single tax or a collection of taxes — are affected by changes in policy actions or in external circumstances. Revenues can change if the tax rate $(s)$ or the tax base$(s)$ changes; revenues can also change if the level of economic activity changes, provided that the tax base$(s)$ is linked in some way to economic activity, as measured by $e_i$. If the tax base cannot change, either because it is not responsive to economic activity, because it requires a deliberate but unforthcoming policy action, or because it is administratively constrained, then the only remaining source of a change in revenues is from a change in the tax rate$(s)$.

Given the difficulty of disentangling these various channels, the actual impact of housing values on local tax revenues remains somewhat illusive. Lutz (2008) estimates that it takes several years (generally about three years) for changes in housing prices to feed through in any significant way to property tax revenues. His empirical results suggest a long-run elasticity of property tax revenue with respect to home prices of only 0.4, in part because it takes time for local officials to adjust assessed values to market values and in part because local officials generally reduce millage rates in response to increases in housing prices. He also finds asymmetric responses of property tax revenues to increases versus decreases in home prices. Relatedly, Lutz et al. (2011—this issue) present evidence that the non-property tax channels have been of relatively little importance in their effects on state and local government revenues, either in the housing market boom/bubble of the early-to-mid-2000s or in the more recent collapse of housing prices during the Great Recession.

Doerner and Ilhanfeldt (2011—this issue) focus more directly on the effects of house prices on local government revenues, using detailed panel data on Florida home prices during the 2000s. They conclude that changes in the real price of Florida single-family housing have an asymmetric effect on government revenues: price increases do not raise real per capita revenues, but decreases tend to dampen revenues. Like Lutz (2008), they conclude that these asymmetric responses are due largely to lags between changes (positive or negative) in market prices and assessed values, to caps on assessment increases, and to decreases in millage rates in response to increases in home prices. They also find that the indirect links between home prices and local government revenues (e.g., estate transfer taxes, sales tax revenues on home construction materials, income taxes on construction-related employment, and wealth effects from home values on sales tax revenues) are generally small, with the exception of an additional channel via impact fees, which are of some importance for many Florida local governments and which are affected in significant ways by changes in home prices.

Some other recent work focuses more specifically on the effects of property tax limitations on local government revenues.4 Skidmore and Scorsone (2011—this issue) analyze Michigan municipalities, and find

1 See http://www.census.gov/govs/estimate.
2 The assessment process is analyzed in detail by Diaz (1990), Quan and Quigley (1991), Wolverton and Gallimore (1999), and McAllister et al. (2003).
3 For empirical estimates of these wealth effects, see Attanasio et al. (2009), Bostic et al. (2009), and Campbell and Cocco (2007).
4 There is a large literature on the effects of tax limitations. For useful general discussions, see Preston and Ichniowski (1991), O’Sullivan et al. (1995), and Dye and McGuire (1997). The entire issue of Public Budgeting & Finance (Volume 24, Number 2, December 2004, “Tax and Expenditure Limitations: A Quarter Century after Proposition 13”) is devoted to tax limitations.
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