Regional Science and Urban Economics 41 (2011) 382–393

Contents lists available at ScienceDirect

Regional Science and Urban Economics

journal homepage: www.elsevier.com/locate/regec

Property tax limitations and local fiscal conditions: The impact of Proposition 2½ in Massachusetts ☆

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ARTICLE INFO

Article history:
Received 11 September 2010
Received in revised form 5 March 2011
Accepted 20 March 2011
Available online 13 April 2011

JEL classification:
H71
H72

Keywords:
Tax and expenditure limitations
Local fiscal conditions

ABSTRACT

In Massachusetts, Proposition 2½ limits local property taxes to 2.5% of assessed value (the "levy ceiling") and restricts the current limit on property tax revenue (the "levy limit") to an annual growth rate of 2.5%. Town residents can vote to override the 2.5% increase in the levy limit, but not if it exceeds the 2.5% levy ceiling. An override results in a permanent increase in the city or town's levy limit. We look at the role that Proposition 2½ has played in the fiscal conditions of towns in Massachusetts. To do so, we develop a model of Proposition 2½ override activity and local fiscal condition. We estimate the model using panel data on Proposition 2½ override attempts since the mid-1980's as well as other town-level socioeconomic and fiscal information. Using a fixed effects estimator, we find that passing a reasonably sized override can significantly strengthen local fiscal condition, both in the short-run and long-run. Further, previous override attempts increase the likelihood of current override activity.

The recent economic downturn has resulted in difficult times for local governments. Cuts in state aid have a disproportionate impact on poorer towns. These towns have been less able to attempt and to pass overrides and hence they have not been able to reap the benefits that this has for their fiscal condition. They are faced with reducing expenditures (e.g. teacher layoffs) or passing overrides to increase revenues. We find that worsening fiscal conditions lead to more overrides so we expect to see more override activity in the near future.

1. Introduction

In 1978, California's Proposition 13 touched off what some have called "The Modern Day Tax Revolt" when voters overwhelmingly approved an initiative that resulted in a large reduction in property taxes and imposed strict limits on future increases. The tax-cutting initiative drew nationwide attention: within two years, 43 states had implemented some kind of property tax reduction or limitation (Sears and Citrin 1985). One of those measures was the voter-initiated and approved Proposition 2½ in Massachusetts, which at base placed a cap on local property taxes of 2.5% of assessed value (the "levy ceiling") and restricted the current limit on property tax revenues (the "levy limit") to grow by no more than 2.5% annually.

Proposition 2½ provides an interesting case study of taxpayer preferences and local democracy in that a simple majority of a local government's voters can approve an annual increase in the levy limit beyond the 2.5% growth rate, an action known as a property tax override. The most common rationales for such action would be a need for public services or facilities that property tax revenues were insufficient to fund under the limit, or in response to stagnation or loss of revenue due to insufficient property tax base growth and/or a reduction in state aid. The impact of the current economic conditions is a perfect case in point.

The purpose of this paper is to evaluate the role that Proposition 2½ has played in the fiscal conditions of towns in Massachusetts and to analyze how the slowdown in the housing market and subsequent effect on assessed values is likely to affect its use and success during the current economic downturn. Has Proposition 2½ been a factor in putting some towns in their current financial straits? Further, is this impact different for rich and poor towns (i.e. those towns with high and low values of per capita income)? What is the likelihood of passing overrides under the current economic conditions? Is the likelihood different for rich and poor towns?

To answer these questions, we develop a model of Proposition 2½ override activity and local government fiscal condition. We apply a fixed effects estimator using panel data for 1987–2009 for the 351 towns in Massachusetts. We find that successful override votes can significantly improve local fiscal conditions, both in the short-run and

☆ We would like to thank Kathy Bradbury, Yolanda Kodrzycki, Gib Metcalf, Amy Schwartz, Bo Zhao and participants at the Urban Institute's Conference on the Housing Crisis and the Effect on State and Local Governments and the New England Study Group for their useful comments and Roger Hatch, Katrina McCarty, Abby Dosoretz, and Avanthi Witana for data assistance.

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doi:10.1016/j.regsciurbeco.2011.03.008

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We provide details of Proposition 2½ in Section 2. In Section 3 we survey the relevant literature. Section 4 provides a basic analysis of trends in property taxes and local fiscal conditions in Massachusetts since the passage of Proposition 2½. In Section 5, we develop the model of Proposition 2½ and local fiscal condition. We provide estimation results in Section 6 and conclusions are laid out in Section 7.

2. Details about Proposition 2½

Economic and political factors set the stage for the enactment of Proposition 2½ in Massachusetts. Real family income for Massachusetts residents made almost no gain in the 1970s, after twenty years of strong growth. Meanwhile Massachusetts statewide government was facing expenditure pressures on several fronts, including increased spending due to a state takeover of welfare and a major expansion of the state's junior college system. Adams (1984) notes that direct *state government* spending rose from 6.8% of Massachusetts personal income to 9.6% between 1970 and 1974 alone.

Program expansion required new revenue, and taxes grew quickly in Massachusetts to pay for it. Massachusetts residents saw their overall state and local tax effort as determined by the US Advisory Commission on Intergovernmental Relations (1994) rise from an already high 129 (29% above average) in 1975 to 133 in 1977 and 144 in 1979, second highest in the nation to New York. By 1977, Massachusetts property taxes per capita were almost twice that of the average state (Cutler et al., 1999). In 1980, the year Proposition 2½ was on the ballot, local property taxes provided 49.5% of the general revenue of local governments in Massachusetts, compared to 28.2% in the average state. (Bradbury and Ladd, 1982).

Facing some of the highest property taxes in the nation, the news of California's Proposition 13's passage in 1978 and reduction of property taxes there energized Massachusetts citizens, who also had access to the ballot through the initiative process, a leading predictor of the imposition of tax and/or expenditure limitations (TELS) in states. (Mullins and Wallin, 2004).

On November 4, 1980, Massachusetts voters approved Proposition 2½ by a margin of 59%–41%. The measure limited local property taxes to 2.5% of assessed value and restricted growth in the levy limit to 2.5% a year. Many localities were well above the 2.5% level and thus were forced to reduce their collections. The measure did allow residents to vote to override the 2.5% increase in the levy limit, but not if it would exceed the 2.5% levy ceiling. An override results in a permanent increase in the town's levy limit (increasing the base for each successive year's allowable 2.5% increase). To do this, the town's selectmen or a town or city council must by majority vote place the override on the ballot, in some cases with the approval of the mayor (Commonwealth of Massachusetts).

In an analysis of the vote for Proposition 2½, Ladd and Wilson found that as in California, taxpayers thought that they could cut taxes without any reduction in services (Ladd and Wilson, 1982). Their findings included over 80% of respondents believing that government spending could be reduced by 5% without a reduction in the quantity or quality of services, while 60% thought a cut of 15% or more would not have any impact.

The impact of Proposition 2½ on Massachusetts local governments would have been more dramatic had the state legislature not made several amendments to it. Chief among them was the 1981 amendment to allow property taxes on new growth in assessed value that is not due to reevaluation to be added to the 2.5% allowable increase in the levy limit, in effect to pay for the increased demand on the services they would produce. The amount added to the levy limit is the product of the increase in qualifying assessed valuation times the prior year's tax rate for the relevant class of property. The legislature also gave voters the option of approving a *debt exclusion* to raise property taxes more than 2½% to pay for debt service for capital projects, with the increase limited to the life of the debt, and *capital outlay expenditure exclusions*, good only for the year the project occurs (Wallin, 2004). As opposed to an override, neither type of exclusion becomes a permanent part of the base used to calculate the limit for future years.[1] Our analysis focuses on overrides as they represent the only *permanent* increase in property taxes approved by the voters.

3. Literature review

Bradbury (1991) asks two questions: "Do citizens get what they want from the public sector?" and "What is it they want?" She looks at the passage and implementation of Proposition 2½ in Massachusetts as a way of answering these questions. Bradbury notes that the "conventional wisdom says that the Commonwealth's voters approved Proposition 2½ because they no longer trusted local officials to serve the best interests of residents." Page 7. Hence, the passage of Proposition 2½ was a way for community residents to gain control of the budget. The limitation on the property tax level along with the override process lets residents decide on the level of local public goods services that they want. But, Bradbury points out three reasons why this might not be the case; 1) the ballot is set by local officials (this has led to menu ballots which have multiple override proposals on each ballot), 2) the provision of local public services is dictated by public officials, and 3) voters are not representative of all residents and they can be influenced by special interest groups.

Bradbury runs regressions of whether or not a town attempted an override and passed an override in fiscal year 1991. The regressions only include 306 of the 351 towns due to missing data restrictions. Towns that attempted at least one override vote had higher incomes per capita, lower new growth as a percent of the previous year's levy limit, and lower levels of excess capacity and were less likely to have a city government (5% significance level). They also tended to be smaller and have lower property tax rates (10% significance level). Similar results are obtained when the dependent variable is whether or not a town passed at least one override (both conditional and unconditional on attempting an override). Bradbury concludes that voters in many towns in Massachusetts do appear to get what they want from the Proposition 2½ override process. But she notes that one problem with the override process is that towns in most need of additional public services; those with relatively low incomes, are less likely to pass an override. This places a greater burden on the state to address disparities in towns' revenue raising capacity.

Cutler et al. (1999; hereafter CEZ) use data on the vote for Proposition 2½ to understand why communities supported it. They find two reasons for this. First, Massachusetts residents believed that government spends revenues on projects that they did not want. Second, people viewed their high taxes as evidence that governments were inefficient. As a result they voted for Proposition 2½ as a way to limit wasteful government spending and inefficiency. CEZ were also interested to discover how resident felt about Proposition 2½ over a decade after voting it into law. They point to the substantial override activity as evidence that residents regretted the strict limits they imposed on property taxes.

[1] See Commonwealth of Massachusetts, Department of Revenue, "Everything You Always Wanted to Know About Levy Limits … But Were Afraid to Ask: A Primer on Proposition 2½" for further explanations.