A Convenient Truth: Property Taxes and Revenue Stability

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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 sources, the dominant is by far the property tax. According to the United States Census Bureau (http://www.census.gov/govs/estimate), 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) in 2010.

A natural question is whether this heavy reliance is appropriate. Many approaches have been used to examine how a local government should determine its tax policies, including what might be termed an "optimal tax" approach, a "portfolio" approach, a "tax smoothing" approach, a "political economy" approach, and a "tax assignment" approach, among many others. In all cases, the appropriate tax structure represents a tradeoff among conflicting goals (for example, efficiency, equity, adequacy, growth, stability, simplicity, and electability), chosen subject to various constraints (for example, achieving a revenue target, minimizing revenue volatility, meeting distributional requirements, and satisfying constituents).

In this broader context, local government reliance on the property tax has strengths and weaknesses. There is some evidence that the property tax has at least a proportional and often a progressive effect on the distribution of income. Given the relative immobility of the base, the tax is unlikely to seriously distort land markets, and it may in some circumstances actually improve the efficiency of resource use. The immobility of the tax base also makes it easy to identify and capture that base and enables the properties to be the natural collateral in cases of nonpayment. Because of its immobility, the property tax base also captures the value of location-specific capital investments and benefits from local government programs and services not otherwise captured through various fees, user charges, and other taxes. The property tax tends to fall on those with a greater ability to pay because immobile property can be the primary repository of wealth. Because property can be assessed by physical inspection, the tax is difficult to evade; indeed, local government officials are well situated to collect the tax. As a highly visible and politically sensitive revenue instrument, the property tax can serve as a perfect tax to encourage more responsive, efficient, and accountable local governments, especially because the tax can be viewed in part as payment for local services.

The property tax also has major problems. The property tax is often rated in polls as among the least popular of all taxes. It is a highly visible tax to taxpayers because they typically pay it directly.

Property tax administration is often arbitrary and idiosyncratic, especially in the procedures used to determine the value of properties; when the procedures used to generate this assessed value are performed incompetently, or even corruptly, individuals rightly perceive the tax as unfair. The tax base is typically distributed across local governments in very uneven ways, which contributes to extreme fiscal disparities across jurisdictions. Perhaps as a result, the property tax is often perceived by individuals as a regressive tax, one in which greater burdens are imposed on lower income than on higher income households.

Finally, the revenue potential of the property tax is seldom fully realized, due largely to significant administrative problems in identifying properties, valuing them, adjusting valuation over time, collecting revenues, and enforcing penalties. Revenue also suffers from politically imposed restrictions on property tax administration and revenue growth. These factors make the property tax an especially inelastic source of revenues. Exemptions are one problem. Governmental, educational, religious, agricultural, and nonprofit properties are frequently exempt from the property tax. Exemption thresholds are common for low-value properties, and owner-occupied, residential, or agricultural properties often receive differential (and lower) valuations than commercial or industrial properties. It is common to provide exemptions and tax relief for social purposes aimed at low-income families, widows, and retired and elderly people. Valuation is another problem. Property transactions do not occur at regular intervals, a practice that makes it necessary to impose the tax on some estimate of each property's value and to use some method to adjust this value over time for changes in prices. Experience also demonstrates that it is difficult to generate large amounts of additional new revenues from the property tax via short-term reforms. Both problems make the property tax an especially inelastic source of revenues, one that does not grow automatically, or even easily, over time.

Many of these claims—especially about its progressive effect on the distribution of income and its nondistortionary effects on resource allocation—have not gone uncontested, as documented in Oates (2001) and Bahl, Martinez-Vazquez, and Youngman (2010). Views on the many effects of the property tax are often wildly conflicting.

Even so, one largely uncontested feature of the property tax—its inelasticity—that is often cited as a weakness of the tax has, I believe, proven to be an important and neglected advantage in the recent national economic recession. Indeed, local government reliance on the property tax rather than on more elastic revenue sources like income, sales, and excise taxes has—so far, in any event—helped local governments to avoid some of the more severe difficulties experienced by many other governments in the "Great Recession" that lasted officially from December 2007 to June 2009. Given the institutional realities of property tax administration, it may take several assessment cycles (for example, many years) before changes in market property values are reflected in assessed values and, ultimately, in property tax collections. Local jurisdictions also routinely adjust millage rates to bring revenues in line with expenditures; this feature is, of course, available for other taxes, but it is a far more common occurrence for the local property tax.

Indeed, recent work by Alm, Buschman, and Sjoquist (2011, 2009) documented that, despite the overall decline in property values in the United States attributable to the bursting of the housing bubble before the start of the Great Recession, the experiences of local governments were quite varied. Indeed, many local governments were able to avoid the significant negative budgetary effects that afflicted state and federal governments. Although housing price declines clearly affected property tax revenues in many jurisdictions, they did so with a significant lag, and they could be offset, at least in part and at least for a time, by discretionary policy changes.

These findings suggest that local government reliance on the property tax has been a largely positive feature in recent years; that is, local government reliance on the property tax has proven to be "a convenient truth." This reliance seems likely to continue in at least some form for the immediate future, and much evidence suggests that this reliance should not be discouraged.

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