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June 23, 2008

PROPERTY TAX LIMITATION IN THE SENATE HOUSING BILL IS UNNECESSARY, IMPRACTICAL, AND LIKELY TO CAUSE HARM

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Legislation that the Senate is considering in response to the ongoing foreclosure crisis (H.R. 3221) includes a provision that would allow non-itemizers to deduct property taxes up to an amount of $500 for an individual and $1,000 for a couple.[1] It would deny the deduction, however, to residents of any locality that raises its property tax rate between the time of the enactment of the legislation and December 31 of this year. An exemption from this denial is granted to residents of some — but not all — localities that raise property tax rates, depending on how and why the rates are raised.

By preventing localities from raising tax rates to help compensate for shrinking property tax revenues resulting from declining home values, the provision could force many localities to cut police, schools, and other vital public services. It also would improperly interfere with local taxing powers and set a precedent of discriminating among localities on the basis of their method of enacting local property tax changes. Finally, it likely would be impossible for IRS to administer this complex provision.

Property Taxes Support Vital Services

Property taxes support vital services such as police and fire departments, road maintenance, libraries, parks, and social services, and are a major funding source for schools in most states. In the areas hardest hit by the housing crisis, property values are falling. Property taxes are calculated as a rate times the assessed value of a house. If values are falling, property tax revenues will fall unless the rates are raised.

Unfortunately, the cost of providing police and fire protection, maintaining roads, and providing other services does not diminish when property values fall. Nor does the number of children who must be educated drop. If localities do not have the flexibility to offset even a portion of this revenue loss by raising property tax rates, they will have to cut police forces, close fire stations, and potentially lay off teachers or take other drastic action to cut K-12 education.

Indeed, a high level of foreclosures places extra burdens and extra expenses on localities. There is a need to police areas with abandoned housing, assist families that have lost their homes, and house

[1] The provision is Sec. 3012 of the Dodd-Shelby Substitute to the House bill.

Language of Property Tax Limitation in the Senate Bill

EXCEPTION.—The real property tax deduction shall not be allowed in the case of a taxpayer living in a jurisdiction in which the rate of tax for all residential real property taxes is increased, net of any tax rebates, through rate increases or the repeal or reduction of otherwise applicable deductions, credits, or offsets, at any time after the date of the enactment of this paragraph and before December 31, 2008. This subparagraph shall not apply in the case of a jurisdiction in which the rate of tax for all residential real property taxes is increased pursuant to an equalization policy in effect before the date of the enactment of this paragraph or as a result of any votes of the residents of such jurisdiction to increase funding for pre-school, primary, secondary, or higher education. (H.R. 3221, Sec. 3012)

the newly homeless. These responsibilities cannot be met if property tax revenues are declining and localities are barred by federal law from raising rates.

As discussed below, however, property tax rate increases are almost always a last resort. Property taxes are one of the least-liked taxes. As a result, local policymakers rarely raise rates unless unacceptable budget cuts would be required if they did not do so.

Senate Provision Would Treat Localities Unevenly

The Senate provision would deny the newly created property tax deduction to individuals living in jurisdictions that raise property tax rates, unless the rate is increased "pursuant to an equalization policy" already in effect or "as a result of any votes of the residents of such jurisdiction to increase funding for pre-school, primary, secondary, or higher education." It is unclear what is meant by "equalization policy" in this context; the term is not being used as it usually understood in state and local finance.[2]

The second exception is for school property tax rate increases enacted by a popular vote for education. It leaves out property tax rate increases used for other purposes, which would be a problem for localities that determine they need to raise rates to support police and fire protection and other vital services. This exception also leaves out rate increases approved by elected officials, rather than through a specific vote of the residents.

Even for schools, the language is problematic. It could pose particular difficulties in jurisdictions where schools are considered part of a city or town and there is not a bright line between school property taxes and other types of property taxes. For example, in Maryland and Massachusetts, schools are considered part of local governments and do not have separately stated property tax levies. This is also true in Virginia, Tennessee, the largest cities in New York (New York City, Syracuse, Yonkers, Buffalo, and Rochester), the District of Columbia, and other places.

It also is a problem to exempt school property tax rate increases that are enacted by a vote of the people and not those that are enacted by a vote of a legislative body such as a school board or city

[2] Equalization usually applies to a method of providing state aid to localities in which the state gives more aid to low-wealth localities in which a specified property tax rate raises less revenue than in a wealthier community. It also is sometimes used as a way for a state to reconcile assessment practices among communities in the state as a step prior to providing such aid.

council. Different states have always had different ways of enacting budgets and taxes. It is inequitable to treat localities in different states in a disparate way depending on which method they use.

Limitation Is Not Necessary Because New Deduction Will Not Lead Localities to Raise Rates

The limitation on property tax rate increases appears to have been included in the legislation because some policymakers feared that the new deduction for non-itemizers would lead localities to raise property tax rates by a similar amount, and thus individuals would not benefit from the new deduction. This fear is unfounded for a number of reasons.

- First, there is always considerable taxpayer resistance to property tax rate increases. At the current time, there is considerable ferment and discussion about property taxes throughout the country, and there are movements in various states for differing types of limitations. It would be highly unusual for a state or local policymaker to propose raising property tax rates unless it was absolutely necessary to maintain services.

- Second, localities cannot raise rates just on people who are taking advantage of the new deduction; if rates are raised, it would affect all homeowners. The majority of homeowners already itemize their deductions, so the new non-itemizer deduction that would be taken by a minority of homeowners would not create a strong incentive to raise tax rates.

- Finally, the proposed non-itemizer deduction is capped at $500 for an individual and $1,000 for a couple. The majority of people who would benefit from the non-itemizer deduction already pay property taxes that exceed these amounts. While the deduction would provide some assistance to homeowners in paying the property taxes they already owe, for most people it would *provide no assistance in paying a property tax increase* because their property taxes already exceed the cap. This is another reason why the new non-itemizer deduction would not create a significant incentive for localities to raise property tax rates. (The primary group that would benefit from the proposed new deduction would be homeowners who no longer have a mortgage, since homeowners with a mortgage usually are able to itemize their deductions. Among homeowners without a mortgage, 63 percent pay property taxes that exceed $800 a year.[3])

The second and third points, taken together, suggest that there need not be concern about triggering property tax rate increases, because the deduction could offset any such increase for only a very small share of taxpayers. Elected officials would still have to answer to the majority of homeowners if they raised tax rates.

[3] U.S. Census Bureau, 2006 American Community Survey, Table B25102. Among homeowners with a mortgage, 81 percent pay property taxes that exceed $800.

Limitation Is Unwarranted Federal Interference with State Authority

In our system of federalism, states — not the federal government — grant taxing power to localities. If the federal government decides to create a new tax break in the form of a property tax deduction for non-itemizers, it should do so *without* interfering with state and local decisions about the correct ways to structure property taxes, including when and how rates should be set or changed. The federal government should not seek to interfere with local governments' taxing power.

Deduction Could Become an "Extender"

Some people have suggested that this language will not harm the ability of local governments to provide services, because it would only apply to the period between enactment of the legislation and December 31, 2008, thus exempting localities that have already set rates for the coming year. History suggests, however, that once a deduction is included in the tax code for one year, there is a high probability it will become an "extender" that is renewed every year. Examples include the deduction for state and local sales tax, the deduction for qualified tuition expenses, and the deduction for teacher classroom expenses, as well as a host of business-oriented deductions and credits. If this type of restriction on local property tax revenue were continued for several years, it would fundamentally alter the nature of state and local finance in the country and represent a basic change in the principles of federalism. It would be a federal property tax cap that falls unevenly on different states (depending on how they enact property tax changes) and on different types of property taxes. The federal government should not embark on such a radical change in the structure of federalism without a thorough vetting of what it means in the various states and what the short- and long-term consequences might be.

Complex Limitation Could Not Be Administered

The proposal to limit property tax rates also is unworkable. *There are at least 40,000 different towns, counties, and school districts in this country that levy property taxes.* The boundaries of tax-levying jurisdictions overlap in some states, so in those states any given property may be subject to taxes levied by several such jurisdictions. A single property could be subject to tax rates set separately by a town or city, a county, a school district, and a special water district, for example. The house across the street could be in the same town and county, but in a different school district. These tax-levying jurisdictions do not correspond to any nationally recognized boundary measures, such as zip codes.

For *each taxpayer* seeking the proposed deduction, the IRS would have to determine a number of pieces of information:

- whether any of the jurisdictions in which the taxpayer resides had raised property tax rates within the timeframe specified in the legislation;

- whether any deduction, credit, or offset was repealed or reduced within the timeframe specified in the legislation (presumably this would apply to such deductions, credits, or offsets offered by either the state or the localities);

Can States Compensate Localities' Lost Property Tax Revenues?

If the federal government limits the ability of localities to raise property tax rates, states will face pressure to make up the revenue that localities need to maintain services. At the current time, more than half of the states face deficits that average 9 percent of their expenditures. Some states are cutting various forms of aid to localities in order to meet their own balanced budget requirements; states experiencing fiscal stress are in no position to replace lost property tax revenue. In short, this proposal could squeeze state and local services from both ends.

- whether any rate increase that might have occurred was "pursuant to an equalization policy in effect before the date of enactment of the legislation," (whatever that might be interpreted to mean); and

- whether a rate increase that might have occurred was used specifically to increase funding for pre-school, primary, secondary, or higher education and, if it was, whether the rate increase was enacted by popular vote (in which case it would be allowed) or by an elected body (in which case it would not be allowed).

There is *no way* that IRS could develop the intricate, detailed information this would require and use it in the timely processing of income tax returns. There is no central repository of current data on property tax rates or on the precise boundaries of property-tax-levying local jurisdictions, let alone the other information that would be required.

- Individuals seeking the proposed deduction could not accurately self-report this type of information. Very few people pay enough attention to how their property tax is calculated to know this level of detail for each property tax jurisdiction to which they are subject. Homeowners usually are aware of the amount of their property tax but would not be fully conversant with the way that amount was derived.

- Congress could try to impose a mandate on state and local government units to report this information to the IRS. But such a mandate still would not provide the information IRS would need, because there would be no simple, practical way for IRS to map the information provided by jurisdiction to the address of the homeowner.

Conclusion

The limitation on increases in property tax rates that is tied to the new non-itemizer property tax deduction in the Senate version of the housing bill is unnecessary and impractical. In both the short and the long run, it is likely to impede efforts of localities to provide an adequate level of services for their residents, including schools, public safety, roads, libraries, parks, and social services. Moreover, it is an unwarranted and unprecedented intrusion by the federal government into policies that always have been left to the states to determine.