Critique of *Who Pays?*

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The Institute on Taxation and Economic Policy (ITEP)'s report on *Who Pays?* shows property taxes to be regressive in all states, though not as regressive as sales taxes. Yet, according to the *Current Population Reports* of the US Census, in 1997 the top 1% of income receivers took in 16.6% of income; while in 1998 the top 1% of wealth holders owned 38.1% of net worth and 47.3% of financial wealth. The top 20% received 56.2% of income, and held 83.4% of net worth, and 90.9% of financial wealth.[1] Given that property ownership is so much more concentrated than income, how can property taxes be regressive?

1. *Who Pays?* offers very little information about methods or assumptions. So often I will just have to guess what they did.

2. Incidence of benefits. I found it striking that ITEP's list of ten most regressive tax offenders includes only four Southern states: Florida, Tennessee, Texas and Alabama. Their ten states with the highest taxes on the poor included only three Southern states: Florida, Arizona and New Mexico. Southern states, particularly states of the Old South, notoriously provide lower benefits to the poor than do Northern states. Now obviously what really counts is not just the regressivity of tax systems, but the overall incidence of taxes and benefits. I suspect that when we add in the incidence of benefits, the Northern states will look much better compared to the Southern states. (Note that European nations, which rely on the regressive VAT nonetheless provide much greater benefits to lower income levels.)

3. Sales Taxes. I would guess that the study assumes sales taxes are 100% shifted onto consumers. This is a bad assumption. The degree of sales tax shifting depends on how easily consumers can avoid sales taxes, either by making purchases in lower tax jurisdictions or simply buying less. The incidence probably varies substantially from jurisdiction to jurisdiction. In the era of the internet and cheap and fast transportation, sales tax avoidance has become easier, so that more of the burden falls on businesses. I don't favor sales taxes, but let's not exaggerate their regressivity.

4. Property Taxes. There are flaws in ITEP's stated assumptions, and further flaws in hidden assumptions. Here are three explicit assumptions ITEP makes about property taxes (p 9):

5. (Assumption 1) "[T]he property tax usually applies mainly to homes and exempts most other forms of wealth." At the same time. ITEP reports that, "On average, we found that about 40 percent of a typical state's property taxes fall on business (excluding the portion of apartment taxes that we assigned to renters.)" But the share of property taxes that falls on corporate property ultimately falls on the shareholders of these corporations. (Of course the corporate shareholders may live in other states.) In short, property taxes *do not* exempt a most important form of highly concentrated wealth: corporate shares.

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[1] Edward N. Wolff, "Recent Trends in Wealth Ownership, 1983-1998," Working Paper No. 300, (Annandale-on-Hudson, New York, Jerome Levy Economics Institute, www.levy.org, April 2000)

6. (Assumption 2) Value of homes represents a higher share of the wealth of average families than of rich families. This may be true for *first* homes, but it doesn't hold if you include second homes, pied-a-terre's, vacation hotels, etc. etc. I have seen estimates that the value of housing rises with the 1.2 to 1.4 power of income. Hence property taxes on homes are progressive in relation to income.

7. (Assumption 3) "Renters do not escape property taxes." This is a big one. a) First of all, property taxes are not substantially passed on to tenants. Why not? Store owners can pass on a portion of sales taxes by raising prices, reducing sales, but also reducing their costs including tax costs. Landlords face a different situation. Their property tax burden is fixed; it does not depend on level of rents. Assuming they already charge what the traffic will bear, if they raise rents they will just incur vacancies, --and still not reduce their tax burden. b) Recall that property taxes are proportional to the value of property, not the level of rents. The lower the value of property, the higher the ratio of rents to property value, so that near-worthless slum properties charge exorbitant rents—for the obvious reason that such property is expensive to maintain and it is very difficult to collect rents from poor people. So even if property taxes *are* passed on to tenants, the proportion of property taxes must be very small in a poor person's rent. I suspect, however, that ITEP simply assumes that property taxes are passed on *in proportion to rents*.

8. In addition to these three explicit assumptions, there are hidden assumptions. The three most important of these are "income fundamentalism," ignoring the effects of local jurisdictions, and attributing maladministration of property taxes to the property tax itself.

9. Income fundamentalism. ITEP groups tax payers by income. Since they don't specify, one assumes they in fact use AGI, adjusted gross income, which is income after loopholes. The problem with ranking by income is that it generates what is known as "regression fallacy." If you rank taxpayers by a poor measure of true income like AGI, you will wind up with a number of very wealthy taxpayers in lower income categories. Mason Gaffney has dubbed this "the Reagan effect."[2] While he was governor of California, Ronald Reagan paid no income taxes on his very low reported income, while he paid substantial property taxes on his tax shelter ranch. It only takes a few Ronald Reagans to make property taxes look regressive. To avoid regression fallacy, professional statisticians use what's called an "instrumental variable" to rank their data points, that is, a variable loosely correlated with the numbers of interest. For example, if you rank taxpayers by the average property value in their zip code, you would avoid the Reagan effect.

10. Effect of local jurisdictions. Property taxes originally supported both state and local governments; the original function of state boards of equalization was to prevent localities from underassessing property in order to reduce their share of state property taxes. Today, property taxes are mostly local; state-level financing has shifted to income and sales taxes. Now there is nothing wrong with using local property taxes to finance improvements to infrastructure like roads and sewers, which increase local property

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[2] M. Mason Gaffney, "The Property Tax is a Progressive Tax" Proceedings of the Sixty fourth Annual Conference on Taxation, sponsored by the National Tax Association, 1971, pp 408-426, http://www.schalkenbach.org/library/progressivet.pdf

values. However, there *is* a problem with using local property taxes—or any other *local* taxes—to finance human services, notably schools and health. Local financing of human services gives localities the incentive to exclude humans—like children, elderly people and poor people—who require services. (A favorite exclusionary technique is large-lot zoning.) The result, by accident or design, is that wealthy jurisdictions provide good services with low tax rates, while poor jurisdictions provide inadequate services with high tax rates. The same result would hold if human services were financed by local income taxes. The cure is to provide substantial support for human services at the state or federal level. But now look what happens when the naïve researcher throws statewide data on property taxes and income into her computer: lo and behold, lower income people apparently pay higher property taxes. But does that make property taxes regressive? No! It just proves that human services should be supported at state and federal levels.

11. Effect of maladministration. Property taxes are maladministered. For many reasons, including bribery, larger properties are underassessed relative to smaller ones. The same goes for our loophole-riddled income tax. Again, the naïve researcher throws statewide data into her computer and concludes the property tax is regressive—compared to an ideal loophole-free income tax. But maladministration is the fault of the administrators. It is another manifestation of income fundamentalism that we recognize and try to correct faults in administration of the income tax; while we dismiss the property tax as flawed and antiquated due to the same failures of administration. If we put anything like the resources into property tax administration that we put into income tax administration, we would have a genuine and effective wealth tax.

12. ITEP favors property tax exemptions such as “homestead” exemptions and “circuit-breakers” for elderly homeowners whose tax to income ratio becomes too high. The trouble with these exemptions is that they give relief to “low income” (remember Ronald Reagan?) property owners, but no relief to low income non-property owners, who must then make up the difference. But isn’t it unfair to impose property taxes on the elderly widow living on Social Security in the house she has occupied for 40 years? However that widow is clearly better off than the equivalent propertyless elderly widow, living in a small apartment. The widow with the house can sell it and live on the income. Or, assuming she now owns the house debt-free, she can get a reverse mortgage, and continue to live in her house, which reverts to the bank on her death. Or—since she is probably holding onto that oversized house to pass it to her children free of capital gains—can’t the kids help her with the property taxes?

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Instead of campaigning to replace state property taxes with state income taxes, we should be campaigning to strengthen the administration of property taxes. Here are some important reforms:

1. Eliminate state-imposed caps and freezes on local property taxes, such as those imposed by California’s notorious Proposition 13. (Prop. 13 saved Standard Oil of California $25 million a year in property taxes.) Caps and freezes protect large property owners from having to support services that would otherwise be demanded by a majority of voters.

2. Eliminate various forms of preferential assessments, such as “use assessments” for agricultural or forest land. Allegedly, use assessments keep agricultural or forest lands from being developed in response to tax pressure. In reality, use assessments simply protect wealthy landowners from property taxes until they are ready to sell. The best way to prevent development on inappropriate land is to encourage development on appropriate land, that is development that fills in suburban sprawl and rebuilds inner cities at higher density. But that’s another story.

3. Partially shift funding of human services to property taxes at the state level. In response to the inequity of rich school districts providing good schools at low rates and vice versa, states like New Hampshire and Minnesota have instituted property tax overrides, which return funds to local school districts on a per capita basis. Minnesota also allows students to attend schools outside the district in which they live. Other states may have moved in this direction; I’m not up on the data. Michigan however froze and capped local property taxes for school finance, replacing the funds with a state sales tax—a back-room maneuver adopted by the state legislature after a public referendum had failed.

4. Upgrade assessment practices. An assessor is supposed to estimate the market value of a property, that is, predict the price at which it would sell. A good assessor can come within plus or minus 5% on ordinary properties like houses. Over the last 20 years, the capacity for accurate assessment has steadily improved due to global positioning technology and better computer programs. Yet the average quality of assessments has steadily deteriorated due to neglect, corruption and clever PR campaigns by the same folks who brought us the death tax. In most jurisdictions properties are assessed at a small but highly variable fraction of market value, which makes it very difficult for small property owners to recognize that they are over-assessed relative to large property owners.

It would be a tragedy if those of us who favor wealth taxes allowed the property tax to slip into oblivion. After all, it is the only tax many rich people pay.