The Variety of Property Tax Limits: Goals, Consequences, and Alternatives

by Joan M. Youngman

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It is not surprising that the property tax gives rise to many efforts to limit tax liabilities, because increases in annual payments can be unpredictable, highly visible, and unrelated to cash income. Politicians and policy analysts who recognize the property tax's strengths must address those difficulties while avoiding or minimizing the creation of new problems in the process. The magnitude of that task can be seen from the experience of states that have undertaken a wide array of property tax restrictions since Proposition 13 initiated a new era of constraints.

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Tax reductions can take many forms, and no one approach will address every cause of dissatisfaction with the current system. Limitations on taxable values will not prevent tax increases if rates rise, and rate limitations may not restrict taxes if values rise. Restricting the total tax burden will not address problems in its distribution among taxpayers. Conversely, an equitably distributed burden may still rise rapidly if total spending increases substantially. All of those may be causes of voter discontent.

Nearly all tax limitation measures also give rise to unintended new problems. Acquisition-value systems that reset property values on sale can dampen real estate markets and impede mobility. State assumption of local spending responsibilities can reduce local fiscal autonomy and thus the ability of local residents to choose the mix of public services and tax prices that best meets their needs. Valuation caps can raise tax rates and increase tax burdens even for taxpayers receiving the benefit of reduced assessments. One consequence of property tax limitations that has received little attention concerns the loss of transparency in the property tax system. Although it is a commonplace that the multivolume Internal Revenue Code is a mystery to all but the most sophisticated tax specialists, the property tax has long been viewed as its polar opposite, the straightforward product of assessed value and a given tax rate. It was in the interest of transparency and accountability that many state courts in the 1960s and 1970s reversed their long-standing acceptance of fractional assessment and enforced legal standards of uniformity in valuation. A review of some tax limitation measures now in place, however, shows how far current systems have fallen from the goal of clarity and accountability. Tax policy now faces the challenge of maintaining transparency and promoting public understanding while integrating limitations and restrictions into the basic structure of the property tax.

Identifying the Problem

Tax limitations take many forms. It is difficult to fashion comprehensive legislative responses to taxpayer discontent because multiple and sometimes conflicting pressures lead to their enactments, including elements such as the following.

Rising Residential Property Taxes Because of Rapidly Increasing Home Values

The increase in property taxes because of rapidly increasing home values was one of the core issues leading to Proposition 13, and the California experience was soon repeated in other regions of the country. After accounting for inflation, housing prices in the United States increased by 45 percent between 1996 and 2005.[1] Of course, a uniform increase in values among all properties in a jurisdiction should not necessarily lead to an increase in any taxpayer's bill if the tax rate drops proportionately to keep collections level. However, it can be difficult for hard-pressed jurisdictions to resist the opportunity to increase revenues without any change in the tax rate.

Increases in Values Are Often Not Uniform Across Property Classes

Voter dissatisfaction may reflect shifts in the tax burden between types of property because of relative value changes. For example, in Chicago, average commercial rents fell 10 percent from 2001 to 2004, at the same time that residential property experienced rapid appreciation.[2] That has also been a problem in the Boston area in recent years.

Anticipated Increases in Residential Property Taxes Following Judicially Mandated Reassessment

Jurisdictions such as New York and Massachusetts have faced great turmoil when state courts overruled fractional assessment systems favoring homeowners after tolerating them for decades or even centuries despite legal requirements of uniformity in taxation. The prospect of increased residential tax burdens led to pressure for corresponding tax relief.

Rising Taxes as a Result of Increased Government Spending

Perceived overspending is a politically potent issue and a natural focus for publicity that can provoke taxpayer discontent. That has led to tax limitation efforts in Florida, even after more than a decade of acquisition-value taxation for homestead property, patterned on Proposition 13.

Unpredictability in Individual Assessments

Unpredictability in individual assessments may be a concern even if total tax collections are stable. Prof. Nathan Anderson has made the case that property owners may find the "insurance value" of limitations on assessment increases worth some amount of higher total taxes or loss of uniformity.[3]

Dissatisfaction With the Level of Property Taxes

Political dissatisfaction does not necessarily depend on whether tax levels are stable or changing, and that dissatisfaction may have multiple causes. For example, some commentators have suggested that court-ordered shifts from local to state financing of public schools may reduce support for the property tax by weakening the link between property taxes and local school spending. The possibility of such a link between the California *Serrano* school finance decision and Proposition 13 has been the topic of lively academic controversy.[4]

Those issues are closely connected and are often not distinguished in public debate. However, their clarification is crucial for the identification of an appropriate solution. A cap on assessment increases may redistribute the tax burden but will not necessarily address overspending by local government. A limit on government spending may not reduce or limit the property taxes on any particular business or residence.

Benefits of the Property Tax

It is important to consider the benefits of an unrestricted value-based property tax when evaluating the relative improvements and drawbacks of a constrained system. Three chief benefits include the property tax's role in supporting independent local government, its function as a signal of the costs and benefits of taxpayer services, and the perceived fairness of a tax burden distributed according to property wealth.

The role of independent local government does not often figure heavily in debate over tax limitation measures, but the California example shows that shifts in intergovernmental responsibilities may be one of the most important unintended consequences of those changes. When financing responsibility shifts to higher levels of government, the loss of fiscal control can be accompanied by a loss of political control over institutions such as public schools.

> ***Shifts in intergovernmental responsibilities may be one of the most important unintended consequences of tax limitation measures.***

The visibility and transparency of the property tax is unquestionably one of the major causes of

[1]Richard F. Dye, Daniel P. McMillen, and David F. Merriman, "Illinois' Response to Rising Residential Property Values: An Assessment Growth Cap in Cook County," 59 *National Tax Journal* 707 (2006), *citing* Dean Baker, "The Housing Bubble Fact Sheet," Center for Economic and Policy Research, Washington, 2005, *available at* http://www.cepr.net/publications/housing_fact_2005_07.pdf.

[2]*Id.* at p. 8.

[3]*See* Nathan B. Anderson, "Property Tax Limitations: An Interpretative Review," 59 *National Tax Journal* 685 (2006).

[4]*See, e.g.*, William A. Fischel, "How *Serrano* Caused Proposition 13," 12 *Journal of Law and Politics* 607 (1996); Kirk Stark and Jonathan Zasloff, "Did *Serrano* Really Cause Proposition 13?" 50 *U.C.L.A. Law Review* 801 (2003).

property tax revolts, yet that high profile has important political benefits. Voters can make informed decisions on local public spending only if they have a sense of its costs and benefits. Complexity and the loss of transparency in the property tax itself, as well as shifts to less-visible taxes such as sales taxes, reduce that political accountability.

It may seem odd to count the fairness of a value-based tax as one of its benefits when the well-known drawbacks of such a tax, including its unpredictability and its lack of a connection to cash income, are major incitements for tax limitation movements. However, a value-based tax responds to one clear concept of equity in the distribution of the tax burden, with properties of equal value bearing equivalent taxes and higher-valued properties responsible for larger tax payments than more modest parcels. That is not a complete or unassailable rationale for the tax. Like most taxes, the property tax is a hybrid structure that reflects historical developments, practical compromises, and multiple goals. It includes elements of a fee for property-related services and contradictory elements of a tax based on ability to pay. For example, a modern office building equipped with new safety features and protected by a private security system may require fewer police and fire services than houses in a declining neighborhood would impose. The relationship of property value to ability to pay can also be attacked on any number of grounds. Real property holdings are not necessarily indicative of wealth, and the gross value of mortgaged property is not necessarily a signal even of property wealth. Despite that, a higher tax on the higher-value property responds to one specific and powerful underlying sense of fairness. A property tax divorced from a market value base can be vulnerable to new forms of public dissatisfaction if the revised distribution of the tax burden does not correspond to a similarly intuitive but widely held sense of fair play.

Patrick Doherty, a tax administrator and former president of the British Institute of Revenues Rating and Valuation, has frequently made the point that a tax must "feel fair" to obtain public acceptance.[5] A tax may fall short on many public finance benchmarks yet still succeed as a revenue instrument if the taxpaying public finds it consistent with a rough sense of justice. The sense that a higher-value property should bear a higher tax can serve as such an indicator in appropriate circumstances. An alternative constrained tax must feel fair if it is to raise significant revenue without new calls for tax limitations in the future.

[5]Patrick Doherty, "Update on Northern Ireland Rating Review," *Insight: Journal of the Institute of Revenues Rating and Valuation* (2003), p. 16.

Limitations and Consequences — Intended and Unintended

Even a brief review of the experience of some states with limitation measures illustrates the many ancillary and sometimes surprising effects of these constraints.

California and Florida: Proposition 13 and Save Our Homes

The acquisition-value tax bases put in place by Proposition 13 in California and similar measures in other states, such as the Save Our Homes amendment to the Florida Constitution, substitute a base-year system for current market values in computing taxable value, with an annual adjustment at the lower of the rate of inflation or a specified percentage (2 percent in California and 3 percent in Florida). The base-year value is then increased to market value on a change in ownership of the property. One important difference between the two states, and between California and most states that adopted some form of acquisition-value taxation, is that California extends that treatment to all property, business and residential alike, while Florida limits it to homestead property, excluding rental and vacation homes as well as business property.

> ***The link between the limitation measure and its unintended consequences may be unclear or attenuated.***

That system responds to the problem of uncertainty experienced by taxpayers in volatile markets, such as California in the 1970s. Under Proposition 13, purchasers can predict with great accuracy their maximum tax liability in future years because both the tax rate and the annual assessment increase are limited. That extreme "insurance value," however, comes at the price of a problematic redistribution of the tax burden. After purchasing a Los Angeles condominium and receiving a tax bill nearly five times the amount owed by the long-time owners of identical property, Stephanie Nordlinger took her ultimately unsuccessful federal constitutional challenge to Proposition 13 to the U.S. Supreme Court.[6] In Florida, owners who have held their property since Save Our Homes instituted a modified form of the California approach have seen their assessments fall far below the market value tax of their property.[7]

[6]*Nordlinger v. Hahn*, 505 U.S. 1 (1992).

[7]One estimate of the average annual growth rate in the Save Our Homes "differential" (the difference between market value and the value as constrained by Save Our Homes) is

(Footnote continued on next page.)

There are a number of reasons why equity concerns and other unintended consequences, such as loss of local control, do not necessarily undermine the popularity of those tax limitation measures. In the first place, the link between the limitation measure and its unintended consequences may be unclear or attenuated. One analyst wrote:

> One major consequence of Proposition 13 was that it effectively transferred control of the property tax from local governments to the state government. Although the property tax still continues to be levied, assessed, collected, and distributed at the local level, Proposition 13 required that the state become the final arbiter in deciding who receives local property tax revenues and how much they receive. . . . [T]he interaction between this state control and other constitutionally mandated requirements at the state level, most notably Proposition 98 [which in 1988 set minimum funding levels for primary education] has led to an environment where the state manipulates the allocation of local property taxes to suit its needs. Thus, although the property tax is generated locally, it is increasingly treated like a state-controlled revenue stream.[8]

Loss of control by California municipalities may be distressing to citizens when they are seeking to influence local school policies, but that dissatisfaction is far removed from any effort to reinstitute a value-based property tax. The existence of a substantial state surplus at the time of Proposition 13's passage also helped insulate local voters from the immediate impact of its revenue cuts. The great complexities of later changes in taxation and expenditure responsibilities, particularly regarding local schools, further weakened any perceived link between causes and consequences.

Also, low rates of tax, such as the 1 percent limit in California, will dampen opposition to what might otherwise be considered inequities in the distribution of the tax burden. The benefit of a limited property tax, combined with the absence of any consensus on alternative approaches, can be sufficient for its support, at least until some new element disturbs this equilibrium.

Finally, many voters feel that a longtime resident who purchased property far in the past at a very modest sum should be protected from unpredictable future valuation increases, but that such protection need not extend to new purchasers with the wherewithal to pay inflated current market prices. The logic of Proposition 13 considered them to be on notice as to future tax liabilities based on their own purchase price but provided protection against unpredictable value increases in the future. In that way, the property tax became a type of installment sales tax — a tax of no more than 1 percent of sale price (with a modest inflation adjustment) to be paid annually over the purchaser's term of ownership.

Note that such a concept of fairness has obvious weaknesses. Subsidizing the resident who purchased property long ago at the expense of new purchasers paying vastly higher prices can be a perverse redistribution of wealth. The longtime owners may have a very small mortgage, or no mortgage liability at all, on an asset that may have greatly increased in value since their purchase. The new buyers may not be individuals of wealth and may need to move because of a change in employment or a growing family. The purchase of an expensive home may leave them burdened with heavy mortgage debt and little net worth. From that perspective, it is not necessarily fair to add to this burden a "Welcome, Stranger" revaluation that greatly exceeds the assessment of identical property held by longtime residents.

> ***An acquisition-value system, like the mortgage finance system that led to the current 'subprime' crisis, is based on faith in ever-rising home prices.***

In that sense, an acquisition-value system, like the mortgage finance system that led to the current "subprime" crisis, is based on faith in ever-rising home prices. Those two issues come together in the case of new homeowners facing rising mortgage rates, an inability to refinance, and the higher property taxes due on a change in ownership. *The Wall Street Journal* profiled the Montes family of Fullerton, Calif., who took on two mortgage loans to purchase a bungalow in a middle-class neighborhood. "Within months, things started going wrong. The Monteses received a letter informing them their property taxes had been reassessed based on the $567,000 sale price instead of its previous $389,000 value. That raised their taxes to $6,000 from $2,900 a year and would have increased their monthly

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54.4 percent since 1995, reaching a total of $404.4 billion or 24.5 percent of total taxable value in 2006. Florida Legislative Office of Economic and Demographic Research, "Florida's Property Tax Study Interim Report" (Feb. 15, 2007), at 13.

[8]Michael A. Shires, *Patterns in California Government Revenues Since Proposition 13* (Public Policy Institute of California, 1999), at pp. 7-8.

payments (including the mortgages and taxes) to $3,931. 'Whoa!' Mr. Montes recalls saying. 'I can't afford this. I went into emergency mode.'"[9]

Those considerations, which were eloquently expressed in the dissents to the state and federal decisions upholding the constitutionality of Proposition 13,[10] have not undermined the popularity of acquisition-value property taxation. Many voters feel that buyers paying seemingly astronomical current market prices are able to pay taxes on that base, that those buyers have no complaint if they are on notice at the time of purchase as to their future tax liabilities (regardless of whether those liabilities are comparable to the taxes on similar property purchased earlier), and, significantly, that a rising real estate market will soon allow those new buyers to enjoy an advantage over even more recent purchasers who will carry a proportionately larger share of the total property tax levy.

As a class, Florida voting residents have benefited greatly from a 3 percent annual limit on assessment increases under the Save Our Homes amendment. The disparate burdens on renters, vacation-home owners, and businesses, who are taxed on the full market value of their property, did not produce any substantial political reaction. However, a downturn in the property market initiated a search for steps that could encourage housing purchases. That, together with a new governor's commitment to property tax reduction, led to a focus on the increased taxes a homeowner would face when selling a residence protected by Save Our Homes and moving to a home with a new acquisition-value tax base. As a result, various proposals raised possible alternatives to Save Our Homes, such as the ability to transfer its property tax savings to a new residence, and an increased homestead exemption.

That is a very thought-provoking example of the unintended consequences of tax limitation measures. The political impetus for Save Our Homes, as its name implies, drew heavily on fears that unrestricted value-based taxes could increase to the point of threatening homeowners, particularly senior citizens, with the loss of their residences. No matter how many protective measures a state may offer, that nightmare scenario is so emotionally powerful as to override all manner of technical rebuttals. More than a decade later, when Save Our Homes had succeeded beyond all expectations in shielding homestead property value from tax, the problem to be addressed was redefined as the lock-in effect, with homeowners reluctant to sell and increase their property taxes. Thus, the problem changed from saving homes to being trapped in homes — an unintended consequence of an acquisition-value tax base. Florida is also grappling with political dissatisfaction over rising local government spending, which is not addressed by assessment limits that redistribute but do not restrain the total tax burden.

> ***In Florida the problem changed from saving homes to being trapped in homes — an unintended consequence of an acquisition-value tax base.***

Interestingly, since 1974 Florida has had a "truth in taxation" measure designed to prevent increases in the market value tax base from leading to hidden tax increases even if tax rates remained unchanged. That legislation requires that after a reassessment communities compute a rolled-back tax rate that would raise the same amount of property tax revenue as the previous year, excluding the effect of new construction and annexation. The new tax rate and the rolled-back tax rate are required to be advertised in the newspaper and mailed to each taxpayer before a public hearing.[11] Such truth in taxation measures can help prevent invisible tax increases when property values rise while nominal tax rates are unchanged,[12] but such procedural safeguards can rarely counter an incipient tax revolt.

Colorado: Limiting the Share of the Tax Base by Class

In 1992 Colorado voters approved one of the best-known limitation measures, the Taxpayer Bill of Rights. That addressed both state and local taxes, requiring a popular vote for any increase in tax rates. Its less-publicized valuation counterpart is the Gallagher Amendment, which a decade earlier responded to tax limitation pressure in the wake of Proposition 13 by imposing an unusual restriction on the growth of the property tax base. The Gallagher Amendment does not limit individual values

[9]James R. Hagerty and Ken Geffert, "One Family's Journey Into a Subprime Trap," *The Wall Street Journal*, Aug. 16, 2007, pp. A1, A9. The article says that Mr. Montes "was able to successfully challenge part of the tax increase," but it does not explain on what grounds. The house lost approximately 6 percent of its market value in the second year of ownership. Under Proposition 8, passed by California voters in 1978, declines in market value below adjusted Proposition 13 base year levels must be reflected in property tax assessments.

[10]*Nordlinger v. Hahn*, 505 U.S. 1 (1992); *Amador Valley Joint Union High School District v. State Board of Equalization*, 22 Cal.3d 208, 149 Cal. Rptr. 239, 583 P.2d 1281 (1978).

[11]Fla. Stat. 200.065.

[12]*See* Gary C. Cornia and Lawrence C. Walters, "Full Disclosure: Unanticipated Improvements in Property Tax Uniformity," 25 *Public Budgeting & Finance* 106 (2005).

Christie's Great Estates/Splash

Saudi Prince Bandar bin Sultan's Hala Ranch in Aspen, Colo., was put on the market for $135 million in July 2006.

or total values, but it permanently restricts the residential portion of the total property tax base *statewide* to 45 percent. Immediately after the Gallagher Amendment was approved, the residential assessment ratio, or the proportion of full market value represented by assessed value, was reduced from 30 percent to 21 percent, and the assessment ratio for nonresidential property was reduced to 29 percent. In every succeeding year, the State Property Tax Division has adjusted the residential ratio to maintain the residential percentage of total taxable value at 45 percent, while the nonresidential assessment ratio has remained at 29 percent. Until the passage of TABOR, the residential assessment ratio could be increased or decreased, but after that time it became subject to TABOR's requirement of a popular vote on tax increases. The residential assessment ratio fell from 21 percent in 1983 to 15 percent in 1990, and under 10 percent in 2000.[13] A 2003 ballot question to fix the rate at 8 percent failed by nearly a 4-1 margin, and by 2005 the rate had fallen to 7.96 percent.[14]

In 1982 few observers could have foreseen the rise in residential property values that some areas of Colorado have experienced since that time, and the resulting drop in the residential percentage.[15] Supporters of the Gallagher Amendment might plausibly argue that this is not an unintended consequence of its passage. They might characterize the voters' interest in residential tax relief as including future tax shifts if Colorado homes grew dramatically in value in the future. But it is difficult to believe that Colorado voters also appreciated and supported the effects of that statewide limit on individual counties. The 45 percent limit considers only the total value of taxable residential and nonresidential property in the state as a whole, and the residential assessment percentage is set accordingly. Each county must then apply that residential percentage to its own taxable property values. The effect on any given county depends on its mix of residential and nonresidential properties and their market values. A largely residential county with little nonresidential property could see its tax base greatly reduced, with its residential property assessed at less than 10 percent of its value and with little nonresidential property available to be assessed at three times that amount. However, a county with little residential property benefits from the higher nonresidential assessment ratio regardless of service demands or revenue needs.

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[13]Gilpin County Office of the Assessor, "Assessment Rate Adjustment Residential Real Property," *available at* http://www.co.gilpin.co.us/Assessor/rate.htm.

[14]Joey Bunch, "Colorado Voters in 'No' Mood," *The Denver Post*, Nov. 5, 2003, p. A1.

[15]The Aspen estate of Prince Bandar bin Sultan, currently on the market for $135 million, may be "the most expensive home sale in American history." Ben Casselman and Christina S. N. Lewis, "'Underpriced' at $100 Million," *The Wall Street Journal*, Aug. 24, 2007, W1.

Perhaps an even more nonintuitive result of the Gallagher Amendment is the effect of property shifts in one county on the tax base of a county in another part of the state. An enormous increase in the value of residential property in Boulder, Aspen, or Vail could raise the residential share of total taxable property value in the state and thus require a reduction in the residential assessment ratio to maintain the legally mandated 45 percent level. Counties whose properties are not increasing in value must apply the lower residential ratio to their tax base, losing taxable capacity.

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Finally, that approach can have unexpected and unintended effects on the distribution of the tax burden among property owners. That will be influenced not only by their taxable property values and the jurisdiction's revenue needs but also by the proportion of residential and nonresidential property within the county. With a statewide residential ratio less than one-third that of the nonresidential ratio, a county with a preponderance of residential property must set a relatively higher rate to raise a given amount of revenue than would a county with the same taxable value but a substantial amount of nonresidential property value. That means that a nonresidential taxpayer in a largely residential county could face the double burden of a higher assessment ratio and a higher tax rate, although TABOR's requirement of a vote on tax increases offers significant protection from rising tax rates in response to falling property values. However, a residential taxpayer in a largely nonresidential county could enjoy the double benefit of a low assessment ratio and a relatively lower tax rate.

New York City: Modified Class Shares

In response to the 1975 *Hellerstein*[16] decision, in which the state's highest court overturned a longstanding but unsanctioned system of fractional assessment, New York state instituted a more complex formula for dividing its tax base among classes of property. In what legislative leaders called a "share of the pie" approach,[17] the new tax system divided property in New York City and Nassau County into four classes: basically, one-, two-, and three-family homes; apartment houses and other residential property; utilities; and all other property. It fixed their proportion of the total tax collections, with changes only to reflect new construction. The growth of individual residential property values was also restricted in New York City and Nassau County to 6 percent annually and no more than 20 percent over five years.

That is an interesting contrast with the Colorado approach. Both states restricted the residential share of the total property tax base, but New York applied that limit only to New York City and Nassau County, while Colorado applied the percentage on a statewide basis. The percentage shares within these two New York taxing jurisdictions have no effect on taxes in other areas of the state, while the Colorado approach produces many intercounty effects. Colorado set a predetermined percentage for that limit, while New York took the existing class shares as the benchmark and allowed changes for new construction. That benchmark was updated in 1984 and 1990, with annual adjustments since 1992.[18] As a result, the share of the New York City tax base contributed by one-, two-, and three-family homes grew from 11.92 percent in 1995 to 14.69 percent in 2005.[19]

That system has definitely redistributed the property tax burden. Class 1 property contributes a portion of total tax collections that represents less than half its share of the market value base; commercial property contributes a portion that is nearly twice its share of the market value base.[20] The assessment ratio applied to the full value of one-, two-, and three-family houses in New York City to arrive at taxable value is 6 percent; for other types of residential property it is 45 percent.[21] The effective tax rate on a rental apartment could be many times the rate on a single-family townhouse.[22] Cooperative apartments and condominiums are required by law to be valued as if they were rental apartments, rather than on the basis of their market value as individual units. Rent regulation in New York City means that those hypothetical rents produce values far below the actual sale price of the condominiums and cooperatives. So rental property bears a much

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[16]*Hellerstein v. Assessor of Islip*, 37 N.Y. 1, 332 N.E.2d 279, 271 N.Y.S.2d 388 (1975).

[17]E. J. Dionne Jr., "State Legislature Approves a New Property-Tax Assessment System," *The New York Times,* Oct. 29, 1981, p. B4.

[18]George Sweeting, "Overview of New York City's Residential Property Tax" (Oct. 31, 2005), *available at* http://www.baruch.cuny.edu/spa/images/pdf/George_Sweeting.pdf.

[19]Martha Stark, "New York City's Residential Property Tax: Policy and Politics," *available at* http://www.baruch.cuny.edu/spa/images/pdf/Martha_Stark.pdf.

[20]*Id.*

[21]Sweeting, *supra* note 18.

[22]The 2005 effective tax rate on single-family homes was 0.534 percent; on Class 2 rental property it was 4.350 percent. *Id.*

heavier effective tax burden than townhouses, condominiums, or cooperative apartments, a disturbing inversion of a market value tax base.

In New York City, rental property bears a much heavier effective tax burden than townhouses, condominiums, or cooperative apartments, a disturbing inversion of a market value tax base.

Several conclusions regarding the New York City system are applicable to other limited-value systems as well. First, the complications of class shares, fractional assessments, and assessment increase limits prevent a clear understanding of the property tax process. In 2007 budget testimony before the New York City Council, City Finance Commissioner Martha Stark said:

> The law is far too complicated. New York City and Nassau County are the only places in the State with fractional assessments, which means people often have to do math just to understand the market value of their property. . . . We are also required to value condos and coops as if they are rental properties. . . . Owners of homes of equal value — whether those homes are horizontal or vertical — should pay the same amount of tax, except where we provide relief for individuals who have fixed incomes. But because of the way we have to treat condos and coops under the law, we cannot achieve this fundamental principle of fairness. State law also caps assessment increases for certain property owners. The caps are incredibly confusing and most taxpayers don't understand that the caps limit the growth of assessments, not taxes or market values.[23]

The New York example also shows the unpredictable effects of a judicial ruling on assessment equity. *Hellerstein* was enormously influential, signaling that a leading court was no longer willing to tolerate the fractional assessment that had long been accepted as a measure of full value. It also led to a revision in assessment practices throughout the state. The new approach in New York City, however, is anything but a straightforward and transparent application of a tax rate to a value figure.

New York City's preferences for owner-occupied residences give a particularly dramatic example of the troubling equity implications of these widespread and popular provisions.

Actual rental properties are greatly disfavored by comparison with more expensive cooperative and condominium properties, which are required to be valued as if they were rental units. Finally, the assessment cap of 6 percent annually and 20 percent for five years for one-, two-, and three-family homes (and a similar 8 percent annual cap and a 30 percent five-year increase for other residential properties with fewer than 11 units) introduces a surprising effect within that class: There are winners and losers even among taxpayers whose values are restricted by that cap. As Commissioner Stark explained, "If you were to scan the *New York Times* Real Estate Section on any Sunday, you could probably find an owner of a $1 million brownstone in Park Slope, one of the wealthiest neighborhoods in Brooklyn, paying less tax than the owner of a $1 million home in Bedford-Stuyvesant, one of Brooklyn's less wealthy neighborhoods. Why? The limits on assessment increases tend to provide larger benefits in neighborhoods where sales prices are rising fast and smaller benefits in those neighborhoods where values are rising modestly."[24] For a city such as New York, with its strong progressive tradition and a preponderance of renters, such disparities evidence the extent to which the workings of the property tax are not understood by voters. The *Gotham Gazette* highlighted the situation of Cita Karan, an adjunct professor at the City University of New York, who paid $1,200 in monthly rent on an annual income of less than $25,000.

> Out of the rent Cita Karan pays each month, $132 of that is estimated to go to property taxes. By contrast, someone who owns a house worth the same amount as Karan's apartment would pay an estimated $30 in taxes. Not only is this inequality dazzling, but it is very close to a complete secret. . . . For renters, who represent two-thirds of all New Yorkers, the property tax is simply a mystery. . . . The poorer New Yorkers wind up paying the most tax.[25]

Oregon: A Base Year Unaffected by Change in Ownership

Oregon's long populist history and enthusiastic use of citizen initiatives have allowed it to enter the tax limitation fray with particular zest. Its residents' diverse political views provide the requisite tension between those who favor a larger role for the

[23]Testimony of Martha E. Stark, commissioner, New York City Department of Finance, before a hearing of the Assembly Real Property Taxation Committee, Apr. 17, 2007, pp. 2-3, *available at* http://www.nyc.gov/html/dof/html/pdf/07pdf/testimony_2007_04_07.pdf.

[24]*Id.* at pp. 3-4.

[25]Glenn Pasanen, "New York's Secret Tax," *Gotham Gazette*, Aug. 20, 2001, *available at* http://www.gothamgazette.com/iotw/propertytax/.

government and those who wish to reduce the state and local tax burden. Oregon has many extremely progressive policies but stands with New Hampshire as one of the few states without a broad-based sales tax. The Portland urban growth boundary, a groundbreaking model for antisprawl city planning, may have helped give rise to Measure 37, which imposed the strictest requirements in the nation for compensation to landowners whose property values are reduced by government regulation. Oregon's land use controls also led to the *Dolan*[26] case, in which the Oregon Supreme Court upheld a locality's requirement that, to obtain a building permit, a landowner dedicate a portion of her property to a public greenway and bike path without compensation. The U.S. Supreme Court overturned that decision, finding that the local government had not established that the required property contribution was proportional to the effect of the proposed development.

> ***In Oregon, so long as the real market value exceeds assessed value, a change in one number does not affect the other.***

Against that background of strongly held and sometimes clashing populist, progressive, and libertarian views, it is not surprising that Oregon has faced a dramatic series of tax limitation initiatives. The first step in its current sequence of property tax restrictions was in part a response to dissatisfaction with market value assessments that tracked rising home prices in the Portland area, and the innovative Portland urban growth boundary that contributed to those price increases. That initiative, Measure 5, passed by a slim majority in 1990, limiting nonschool property tax rates to 1 percent and rates for school funding to 1.5 percent, to be reduced to 0.5 percent under the expectation that the state would assume greater responsibility for education.

Measure 5 adopted one part of Proposition 13, the rate limitation, but did not break the link between assessments and market values. That was the goal of Measure 47, passed in 1996, which sought to limit future assessment increases. However, disagreement about interpretation of its language led the Oregon Legislative Assembly in 1997 to offer voters a clarified version, which was approved as Measure 50. Later tax and spending initiatives, such as Measure 86, which in 2000 required that state revenues in excess of forecast amounts be returned to state taxpayers, did not alter the assessment scheme established by Measure 50.

Just as Proposition 13 turned back the initial base year for assessments to 1975-76, Measure 50 establishes a similar base year for 1995-96. In effect, that supplies the assessment rollback that was missing from Measure 5. However, Proposition 13's approach to valuation, while novel, could be explained in several clear elements: a 1975-76 base year, to be reset at market value on a change in ownership, with no more than a 2 percent annual inflation adjustment. Measure 50's assessment provisions are, by contrast, quite complex:

- The standard concept of market value is now termed "real market value," defined in the state constitution as the minimum cash amount an informed and willing buyer and seller would agree to in an arm's-length transaction.[27]
- A new term, "maximum assessed value," establishes the rollback to assessments in place at the time of Measure 5. After passage of Measure 50 in 1997, the maximum assessed value was set at the property's real market value for 1995-96, reduced by 10 percent.[28] Thereafter, maximum assessed value is always the greater of either 103 percent of the property's assessed value from the previous year or 100 percent of the property's maximum assessed value from the previous year.
- Assessed value is the base on which the tax rate is levied. The assessed value is generally the maximum assessed value or the real market value, whichever is less.
- For property constructed after 1995-1996, the maximum assessed value is obtained by multiplying the real market value by a factor reflecting the relationship of the two in the specific area, but only if that results in a maximum assessed value that is lower than the real market value.

Any thought that that tangle of provisions might be clear to Oregon taxpayers would be dispelled by the decisions of the Oregon Tax Court. In a representative case, a taxpayer successfully challenged the real market value of his home and had that figure lowered from $239,447 to $204,900. As a result, he sought a corresponding reduction in the assessed value on which the tax is levied, particularly after demonstrating that three superior houses "within a stone's throw of his" carried lower assessed values. The tax court explained that taxes were no longer proportional either to actual market value or to the taxes assessed on comparable properties:

> Plaintiff's analysis has two features that are inconsistent with the current state of the law. The first is the reasoning that if the real market value of the property is reduced, a

[26]*Dolan v. City of Tigard*, 317 Ore. 110; 854 P.2d 437 (1993), *reversed and remanded*, 512 U.S. 374 (1994).

[27]Ore. Const. art. 11b, section (2) (a).

[28]Oregon Laws 1997, Ch. 541, section 2.

> corresponding reduction should occur in assessed value. That is the case only if the real market value falls below the assessed value. So long as real market value exceeds assessed value, a change in one number is without effect on the other. The whole point of Measure 50 was to link a property owner's tax burden to a historical number, maximum assessed value, rather than to contemporary sales.
>
> Plaintiff's reliance on the assessed values assigned to his neighbors is also not persuasive. At one point, uniformity of assessment was an important consideration, so much so that the former name of what is now known as the board of property tax appeals was the board of equalization. However, again with Measure 50, the touchstone is the historical assessed value of the property. How those assessed values compare across properties over time, and their relative disparities, is not a cause for correcting the tax roll.[29]

In another case, a couple's property had a maximum assessed value of $362,960, based on a real market value of $514,070, reached during the 2002-2003 tax year. The taxpayers purchased their home in 2004 for $315,000 and understandably felt aggrieved at paying taxes on the higher assessed value that had been reached several years earlier.

> Plaintiffs' point is that using such high market value to set maximum assessed value deprived them of the benefit of Measure 50. . . . Plaintiffs would have the court turn the clock back and correct an appraisal of the property done years ago. . . . A subsequent owner is not able, under Measure 50, to revive the appeal rights available to their predecessor.[30]

Another taxpayer challenged an increase in the assessed value of property from $180,283 to $200,394 in one year, pointing out that this exceeded the 3 percent annual increase permitted in maximum assessed value under Measure 50. The assessor explained that the property had suffered a decline in its real market value. As a result, the maximum assessed value, together with its 3 percent annual increase limit, was not relevant to the tax. Because the real market value was less than the maximum assessed value, the assessed value was based on the real market value rather than the maximum assessed value.

> While Plaintiffs saw an increase of more than 11 percent from one tax year to the next, the increase was due to the fact that the maximum assessed value was a lower number than real market value, and it became the assessed value of the property. . . . The statute makes clear that maximum assessed value is always the greater of either 103 percent of the property's assessed value from the prior year, or 100 percent of the property's maximum assessed value from the prior year. . . . While Plaintiffs' tax burden increased more than three percent during this tax year, that increase is consistent with the historical assessment of the property and is consistent with the clear dictates of the statute.[31]

In all of those cases the Oregon Tax Court was following the interpretation it announced in a 1999 decision:

> The court recognizes that in one sense MAV [maximum assessed value] is somewhat artificial or arbitrary. That is inherent in the overall scheme of section 11 [of the Oregon Constitution]. The concept may, over time, result in various degrees of nonuniformity in the property tax system. Section 11(18) contemplates this and excuses itself from complying with other constitutional provisions requiring uniformity, specifically Article IX, section 1, and Article I, section 32.[32]

The Oregon experience illustrates several lessons concerning property tax limitation measures. First, generalizations can be misleading when they fail to take complex details into account — as was the case for the Oregon taxpayer who thought that Measure 50 limits increases in assessed value to 3 percent annually. Moreover, the most significant aspects of those enactments may be implicit or unstated. None of the explanationss of assessed value, real market value, and maximum assessed value highlights the most unusual feature of the Oregon system: its lack of a reassessment to market value on a change in ownership. Reassessment after sale was fundamental to Proposition 13's concept of an acquisition-value tax base and to its underlying concept of fairness.

The popularity of acquisition value as a tax base in California and in the states that have followed its

[29]*McKee v. Clackamas County Assessor*, Oregon Tax Court Magistrate Division, Small Claims, Property Tax (Nov. 18, 2005).

[30]*McCollum v. Multnomah County Assessor*, Oregon Tax Court Magistrate Division, Property Tax (Nov. 18, 2005). Note that in *Roosevelt v. Montana Dept. of Revenue*, 975 P.2d 295 (Mont. 1998), the Montana Supreme Court overturned part of a state statute providing a 2 percent annual phase-in of new market values. The court found that this imposed a disproportionate share of the tax burden on owners whose property had declined in value, in violation of the Montana Constitution's guarantee of equal protection.

[31]*Kirkpatrick v. Lane County Assessor*, Oregon Tax Court Magistrate Division, Property Tax (Nov. 18, 2005).

[32]*Ellis v. Lorati*, 14 OTR 525, 535 (1999).

lead, such as Michigan and Florida, makes it especially surprising that Oregon should have gone so much farther and broken the link between market value and assessed value, rather than resetting assessed values at market levels on a change in ownership. It is even more surprising that this extremely unusual step should not have received more attention. Finally, this rejection of market value assessment arose in a state that is one of only four without a general sales tax, which increases the need for the property tax to serve as a major source of revenue.

Chicago: The 7 Percent Solution

Chicago lies within Cook County, whose property tax system serves as a major funding mechanism for the nation's third-largest city. Chicago's vibrant growth in recent years has brought with it the problems of rising values familiar to other jurisdictions experiencing strong real estate markets. In Chicago the median house price, not adjusted for inflation, increased by 100 percent between 1993 and 2003, with a 72 percent increase between 1997 and 2003.[33] The Cook County solution was characteristically pragmatic and moderate. The assessor sought authorization from the General Assembly to adjust the homestead exemption to limit annual assessment increases on qualifying owner-occupied property to 7 percent, with a maximum value reduction in any one year of $20,000.

It is also typical of Illinois and of the Chicago government in Cook County that such a seemingly straightforward measure should have many intricacies and politically contentious repercussions. The historic division between state government in Springfield and the city government in Cook County left state approval for that provision even less certain than Albany's sanction for New York City's "share of the pie" approach to dividing its tax burden among property classes. Just as the New York approach ensures that the business property tax is larger than the business share of total property value, restriction of the "7 percent solution" to homestead properties shifted a portion of the Chicago levy to commercial, industrial, and rental properties. But while that shift was permitted in New York on a permanent basis, the politically active and well-organized business taxpayers in Chicago succeeded in limiting the initial period for the shift to three years.

[33]Cook County Assessor's Office, "The Impact of the 7% Expanded Homeowner Exemption: City of Chicago Tax Years 2003 & 2004, North District Tax Year 2004, South District Projected Tax Year 2005" (2005), at p. 5, *available at* http://www.cookcountyassessor.com/forms/7PerCentImpactReport.pdf/.

The Illinois Department of Revenue asked the Institute of Government and Public Affairs (the Institute) at the University of Illinois to prepare a report on the effects of this tax limit.[34] That report, which included 123 pages of tables, provided a sophisticated analysis of the economic impact of the shift of the tax burden from homeowners to business property. It found that eligible homeowners saved an average of 14.2 percent on their tax bills as a result of the limit. Because the tax rate rose to compensate for that reduction in the tax base, all nonhomestead property, including business property and apartment buildings, paid higher taxes than they would otherwise have owed.

One very important detail about that situation concerns the Cook County reassessment cycle. The county reassesses one of its three major regions (Chicago, the northern suburbs, and the south suburbs) annually, so each of the three segments faces updated values once every three years. For example, the annual change in the assessed value of residential property in the city of Chicago was 2.5 percent in 2001, 2.7 percent in 2002, and 37.4 percent in 2003.[35] The 7 percent limit is an annual restriction, so properties that experience double-digit increases in any given revaluation can actually rise 21 percent over the course of a complete assessment cycle.

The Institute's report noted that there are many different ways to measure the effect of that limitation, and each approach has different political implications. For example, the Institute compared the taxes paid by eligible homeowners with the amount they would have paid to raise the same total revenue without the assessment cap. By contrast, the Cook County Assessor's Office compared the proportion of the total tax paid by homestead property and by business property before and after imposition of the cap.[36] The Institute questioned that approach: "There is nothing in Illinois tax law or, as we read it, principles of tax policy concerning aggregate tax shares by class."[37] If commercial and industrial values rise at a lower rate than residential values, should class shares change to reflect that difference? Note that although the assessor's office referred to class shares in judging the effect of the 7 percent limit, Cook County, unlike New York or Colorado, did not adopt a "share of the pie" approach. A limit

[34]That report and some of its findings are discussed in Richard F. Dye, Daniel P. McMillen, and David F. Merriman, "Illinois' Response to Rising Residential Property Values: An Assessment Growth Cap in Cook County," 59 *National Tax Journal* 707 (2006).

[35]The Civic Federation, "The Effects of the '7% Cap' on Property Taxes Paid in the City of Chicago: Tax Year 2003" (Sept. 19, 2005), at p.7.

[36]Cook County Assessor's Office, *supra* note 33, at pp. 9-10.

[37]Dye, McMillen, Merriman, note 34.

on assessment increases is responsive to the problem of unpredictable increases in the tax bills of individual homeowners. Restricting the share of the total tax base contributed by any class of property, as the Colorado experience demonstrates, is far more problematic.

The most dramatic finding by the Assessor's Office was that the median residential valuation increase in Chicago in 2003 was 35 percent, with some neighborhoods rising in value by more than 70 percent and some individual parcels experiencing increases of up to 150 percent.[38] The Assessor's Office also noted that residential tax bills continued to rise and that the nonresidential share of total tax collections continued to decline under the new system. In response, the Institute pointed out that new construction and more rapid increases in the value of existing property could increase the residential share of the total market price of taxable real estate. In that case, it would be appropriate for the residential class share of a value-based tax burden to rise as well. That would hold true for any jurisdiction with a market value property tax. An additional consideration, however, concerns the specific valuation methods used in Cook County. The official assessment ratio for commercial property in the county is 38 percent; for residential property with six or fewer housing units, it is 16 percent. That means that by law the ratio of the commercial assessment ratio to the residential assessment ratio should be 2.375 to 1. The Illinois DOR's assessment-sales ratio studies indicate that the actual ratio dropped from 3.1 to 1 in 1996 to 2.3 to 1 in 2003.[39] One possible reason for that change was a 1996 change in Illinois law to allow Cook County property owners access to the state Property Tax Appeal Board as a forum for property tax disputes.

The Civic Federation of Chicago agreed with the Assessor's Office that total property tax collections from residential property increased by 10.1 percent in the 2003 tax year even after implementation of the 7 percent limit. However, in the absence of the cap, that figure would have been 16.8 percent. As the Federation said, "The total tax amount owed by all other classes combined increased by 2.4% under the cap, but would otherwise have decreased by 2.0%."[40]

That illustrates the distinction between shifts in relative class shares of the total property tax burden that accurately reflect shifting market values and those that do not. The first category operates within and effectuates the intent of a market value tax system. That does not mean that mitigating measures might not still be needed to moderate the effect of sudden shifts on individual taxpayers, but it does mean that continual shifts in class shares are to be expected as relative market values change over time. In this case, changing class shares are not a problem in and of themselves; only their effect on individual taxpayers can be problematic. The change in Cook County assessment ratios over time might be considered a third category, one in which changing class shares actually indicate a shift toward greater accuracy in assessment.

The Cook County assessment ratios illustrate the problem of nontransparent tax measures.

The Cook County assessment ratios also illustrate the problem of nontransparent tax measures. Few citizens can be expected to appreciate that the effective tax rate on nonresidential property was three times the rate on homestead property in 1996, while the official legal standard called for respective assessments ratios of 38 percent and 16 percent. If the cause of that disparity is not understood, its gradual remediation as the assessment ratio changed to the legally required 2.3 to 1 could hardly be expected to counter political unrest over shifts in the property tax burden. To make matters even less transparent, Illinois law requires that property generally be assessed at one-third of market value. Given the special 16 percent and 38 percent classification rates in Cook County, the state DOR applies an equalization factor that brings the county's total assessed value to one-third of market levels. That equalized assessed value, or EAV, is the taxable value used for computing a tax bill,[41] with evident opportunity for confusion.

Finally, the Cook County experience gives vivid evidence of the existence of "winners" and "losers" even within the class of taxpayers eligible for the assessment limit — that is, homestead property owners experiencing annual valuation increases greater than 7 percent. As two of the Institute researchers who analyzed the Cook County experience for the DOR said, "If expenditures remain constant, the limits should lower taxes for favored groups such as homestead properties by raising taxes for groups whose assessments are not restricted — an expected result that comes as no surprise. The surprise is that taxes also go up for

[38]Cook County Assessor's Office, *supra* note 33.

[39]Dye, McMillen, Merriman, *supra* note 34 at 713, citing Illinois DOR, "Final 2004 Equalization Factor for Cook County" (2005), and Theodore M. Swain, Roland Calia, Mark R. Davis, Guerino Turano, and Bill Vaselopolos, "Report of the Civic Federation Task Force on Cook County Classification and Equalization" (Chicago: The Civic Federation, 1999).

[40]The Civic Federation, *supra* note 35.

[41]Cook County Assessor's Office, *supra* note 33, at p.4.

many property owners in the favored groups."[42] That is, higher tax rates are needed to compensate for the limited tax base if revenue is to stay level. All properties pay the higher tax rate, and for properties not subject to the assessment limit, this clearly produces a heavier tax bill — the product of a higher rate with no reduction in the base. But even among properties that benefit from the assessment limit with lower taxable values, the increase in the tax rate will offset some of the benefit of a decreased tax base. Low-value properties experiencing appreciation that is only slightly above the assessment limit could pay more in taxes because of the limit if enough high-value properties experience appreciation dramatic enough to require a sufficiently large increase in the tax rate. Moreover, senior citizens whose assessed values are frozen[43] receive no benefit from the assessment limit but are subject to the resulting higher tax rate.

> ***Does an aggregate savings translate into individual savings if there are winners and losers even within the favored class?***

The phenomenon of winners and losers even among the favored classes has been noted elsewhere, as in Commissioner Stark's hypothetical example of two Brooklyn homes. The Minnesota DOR has studied the effect of that state's limits on assessment increases for four classes of property: residential, agricultural, seasonal recreational residential, and timberland. After computing the increase in tax rates necessary to maintain revenues when assessments were thus limited, the DOR found that more than one-third of the properties in the favored categories and more than 84 percent of all residential homesteads in the state faced higher tax bills as a result:

> In 2007, the Limited Market Value law increased property taxes on 84% of the state's 1.4 million residential homesteads (1.2 million parcels), by $110 million (an average increase of $92 per parcel). For the other 16% of residential homesteads (227,000), the law decreased property taxes by $64 million (an average reduction of $282 per parcel). One-third of the parcels with limited value had an increase in tax. This seemingly counter-intuitive result occurs because the limitation on these residential homestead properties was overwhelmed by proportionately larger limitations on other properties. The net tax increase of $46 million on residential homesteads as a group results from shifts off of other limited classes of property.[44]

The Cook County Assessor's Office took a different approach to calculating the winners and losers under the 7 percent limit. It computed the lower tax rate that, if there had been no limit, would have raised the same amount of revenue as was collected in 2003 and applied that rate to the value taken off the tax rolls by the limitation measure. It concluded, "The aggregate savings translate into individual savings for all eligible homeowners in the City."[45] But note the complexities in the choice of comparison here. Should the 2002 tax bill be compared with the 2003 amount, or should the 2003 amount be calculated with and without the assessment cap and the corresponding increase in rates to raise the same amount of revenue? Does an aggregate savings translate into individual savings if there are winners and losers even within the favored class?

Institute analysts warned of the dangers of limitation measures that undermine the equitable distribution of the tax burden:

> Down the road, a system that allows significant deviations from uniformity is sure to breed hostility and disrespect. Illinois politicians and journalists sometimes refer to the assessment cap as "the seven percent solution." Ironically, this is reminiscent of a line from a Sherlock Holmes story referring to cocaine use. Special tax provisions have an addictive quality, in that they create distortions and inequities, which create a case for other special provisions, which begs for even more.[46]

Massachusetts: Limits on Collections and Rates, Not on Values

Massachusetts was one of the more unexpected converts to the post-Proposition 13 property tax revolt, because its high property taxes had been in place so long (having ranked in the top four states in terms of property taxes per capita for more than 20

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[42]Richard F. Dye and Daniel P. McMillen, "Surprise! An Unintended Consequence of Assessment Limitations," *Land Lines*, Lincoln Institute of Land Policy, July 2007, 8, at p. 9.

[43]Cook County Treasurer's Office, "Senior Citizen Assessment Freeze Exemption," *available at* http://www.cookcountytreasurer.com/services.aspx?ntopicid=24.

[44]Minnesota DOR, "Limited Market Value Report: 2006 Assessment Year" (2007), *available at* http://www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/2007_lmv_report.pdf, at p. 15.

[45]Cook County Assessor's Office, *supra* note 33, at p. 13.

[46]Dye, McMillen, and Merriman, *supra* note 34 (referring to Sir Arthur Conan Doyle, *The Sign of Four*: "'It is cocaine,' Holmes said, 'a seven-percent solution. Would you care to try it?'").

years[47]) as to seem an accepted feature of its fiscal landscape. Its famously liberal environment and political support for generous social spending, however, did not inoculate it from the perfect storm of extremely high property tax rates, outdated assessments, and a court-ordered revaluation that threatened to shift tax burdens dramatically from business property to residential property. In that way the Massachusetts situation closely resembled that of New York state, where literally centuries of judicial willingness to condone fractional assessment systems were replaced with a new activism that gave effect to legal requirements of full-value assessment. The fiction that uniform assessment at a fraction of full value was the economic equivalent of full-value assessment at a lower tax rate was no longer accepted.

Although the Massachusetts Constitution required uniformity in taxation, inaccurate assessments provided lower effective rates for residential property than for businesses and lower rates for longtime residents than for new purchasers. In its new willingness to challenge established "extralegal" classification, the Massachusetts Supreme Judicial Court held that taxpayers who were not treated uniformly under fractional assessment systems had the right to have their valuations lowered, not simply to the jurisdictionwide average assessment ratio, but to the average ratio of the most favored property class.[48] Yet it was not the business taxpayers alone who brought the legal actions that upended those long-standing practices. Suburban communities with accurate full-value assessments protested a distribution of state aid under formulas that took local assessments into account as a measure of ability to pay and so overstated the wealth of the suburbs in comparison to greatly underassessed urban areas.

Boston was an egregious example, having had no full citywide reassessment since the 1920s. In the 1970s its residential property was assessed at a ratio to full value far below that of business property, and utilities were assessed at a ratio far above that of business property. Within those classes there were enormous differences among properties and among neighborhoods. Residential property in the largely minority Boston neighborhood of Roxbury, for example, was assessed at approximately 40 percent of market value, while the comparable figure for Charlestown was approximately 16 percent.[49] Those disparities did not necessarily reflect discriminatory intent; a discriminatory effect would follow any use of decades-old market figures, overvaluing declining neighborhoods and undervaluing those that had risen in price in the interim. The extent of underassessment in these older cities may be gauged from the fact that in 1980 Boston had a nominal tax rate above 25 percent — a rate that would be completely unsupportable if assessments were at all close to market levels.

The 1980 Massachusetts tax limitation can in some ways be seen as an inverted image of Proposition 13.

Against that background, the 1980 Massachusetts tax limitation can in some ways be seen as an inverted image of Proposition 13 even though its popular name, Proposition 2½, proclaimed its heritage from the earlier California measure. Proposition 13 received much of its impetus from a highly accurate assessment system, reformed in the wake of corruption scandals, that tracked a dramatic increase in housing prices in the 1970s. Proposition 2½ was passed at a time when Massachusetts courts were moving to enforce the legal requirement of full-value assessment. Proposition 13's most significant features instituted an acquisition-value tax base and limited tax rates to 1 percent. Proposition 2½ did not alter the market-value basis for the property tax and only limited tax rates to 2.5 percent — a relatively high boundary for a market value system. For local governments, the most significant limit in Proposition 2½ was a restriction of total growth in property tax collections to 2.5 percent annually. In an era of high inflation this threatened to destabilize municipal finances across the state.

State and local governments adjusted to those provisions over time. The first impact was dramatic, with the state DOR estimating that fiscal 1982 local tax collections would be $486 million lower than in the previous year's.[50] However, the new tax rates were phased in, with the possibility of local override votes to increase collections, and, most importantly, significant state aid to help moderate the effect of these reductions. Later amendments modified the 2.5 percent limit to growth in collections by excluding from that amount tax revenue resulting from new construction and allowing "banking" of any unused portion of the 2.5 percent increase for future years.

The critical factor in that successful transition may have been a most unexpected one: passage of a

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[47]Katharine L. Bradbury and Helen Ladd, "Proposition 2½: Initial Impacts," *New England Economic Review*, Federal Reserve Bank of Boston, January-February 1982.

[48]*Tregor v. Board of Assessors,* 377 Mass. 602, 387 N.E.2d 538 (1979).

[49]Robert F. Engle, "De Facto Discrimination in Residential Assessments: Boston," 28 *National Tax Journal* 445 (1975).

[50]Bradbury and Ladd, *supra* note 47.

constitutional amendment explicitly allowing higher rates of tax on business and commercial property than on residences. By 1987, 85 of the state's 351 taxing jurisdictions had adopted that type of classification, reducing the residential share of property taxes by an average of 8 percentage points.[51] Thus, Massachusetts joined New York and several other states in which a judicial decision overturning unauthorized classification was followed by enactment of an explicit, legal system of classification. That step was disturbing to those who valued uniformity in taxation, but the constitutional requirement of uniformity had long been ignored in favor of de facto classification. The new amendment, which set limits on the degree to which class tax rates could diverge, was far different from the previous regime, in which outdated assessments and the individual assessor's judgment could produce a system in which there were nearly as many classes as taxable properties.

Passage of the classification amendment also helped counteract fears that new, accurate assessments would be subject to the extremely high tax rates formerly prevailing in older urban areas. Those fears were inflamed by local politicians who sought to avoid the political backlash that might accompany loss of the homeowner benefits provided by fractional assessment. Boston Mayor Kevin White distributed a pamphlet warning homeowners that they would face an effective tax rate of $100 per $1,000 under full-value assessment. "I'm not about to sit still and let 100% valuation destroy Boston," he wrote.

The classification amendment passed, allowing many localities to shift their tax burden legally from residential to business property. One study found that by 1987 communities adopting classification had a residential share of the total property tax burden 3 percentage points lower than it had been in 1980, while communities that did not classify experienced a residential burden three points higher than in 1980.[52] However, that was a restricted shift subject to state oversight. "Although communities that 'overtaxed' businesses in 1980 did not typically do so to a greater degree than those that had classified tax rates in 1987, fewer communities have chosen to take the classification route than had previously overtaxed nonresidential property via overassessment."[53] For example, a community with little business property would not find classification a useful option, even if what business property existed there had been overtaxed in 1980.

[51]Katharine L. Bradbury, "Shifting Property Tax Burdens in Massachusetts," *New England Economic Review*, Federal Reserve Bank of Boston, September-October 1988, 36, at p. 42.

[52]*Id.* at p. 44.

[53]*Id.*

It is not surprising that the classification amendment passed, but many analysts were surprised that classification proved the mechanism for effectuating full-value assessment. The classification amendment required the DOR to certify that a locality had implemented valuation at 100 percent of market levels before it would be permitted to institute different tax rates for different types of property. Boston completed its revaluation in 1983, after Proposition 2½ had been in effect for one year. In 1981 the DOR had judged fewer than 100 of the state's 351 cities and towns to have implemented market value assessment; by 1985 all but 12 had met that standard.[54] The effect on statewide uniformity was also impressive:

> In 1980 effective property tax rates ranged from 11 percent in Boston to 0.5 percent in the tiny (population 500) town of Chilmark on Martha's Vineyard. By 1987 the range had narrowed: the maximum (not surprisingly) was 2.5 percent and the lowest tax rate was 0.3 percent in Chilmark.[55]

At the same time, the requirement that tax rates be no higher than 2.5 percent also provided an obvious impetus for revaluation. Cities and towns with higher tax rates were required to reduce their collections by 15 percent annually. Seventy-nine percent of the state's population resided in jurisdictions with rates above that level.[56] The effect of these cutbacks could be severe, and the limitations imposed by Proposition 2½ continue to constrain local spending. A 2007 report said, "Some Massachusetts towns have had to lay off school and municipal employees (including firefighters and police), freeze wages, close town libraries and senior centers, and stop funding infrastructure projects to comply with the state's severe property tax cap."[57]

Massachusetts thus offers an example of a different approach to tax limitation: a populist initiative intended to reduce tax rates and tax collections rather than to implement a non-market-value tax base. In fact, the combination of judicial willingness to enforce full-value assessment and the option of legal classification if the community were certified at full-value taxation actually brought taxable values to accurate market levels in a state that had

[54]*Id.* at p. 37.

[55]*Id.* at p. 38.

[56]Bradbury and Ladd, *supra* note 47.

[57]Karen J. Lyons and Iris J. Lav, "The Problems With Property Tax Revenue Caps," *State Tax Notes*, Aug. 13, 2007, 429, *Doc 2007-15710*, or *2007 STT 157-1*, citing Massachusetts Municipal Finance Task Force, "Local Communities at Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," (September 2005), *available at* http://www.mapc.org/Municipal_Finance_Task_Force/Local%20Communities %20At%20Risk%20Report.pdf.

tolerated many decades of outdated assessments. That was in itself an extraordinary achievement, and for it to have taken place in the context of a citizen-initiated tax revolt is nothing short of astonishing. That structure has remained relatively stable for 25 years. It is now being tested by new market developments in which buoyant residential prices have been accompanied by flat or declining commercial rents. Those shifts in class shares of the property tax base have threatened to undo the classification compromise by which preferential treatment of homeowners was retained even under a full-value system. The legislature responded by permitting a limited and temporary expansion of the homeowner benefit under classification, but the ultimate result of this economic and political cycle remains to be seen.

Lessons and Alternatives

These approaches to property tax limitations convey some of the variety and complexity of such measures. They also permit some preliminary observations for more detailed future analysis.

Assessment Caps

The most common response to criticism that property taxes are too high is an effort to restrain tax bills by limiting assessed values. That can have several problematic effects. First, deviations from market value undermine the vertical and horizontal equity of a tax on real property. There can be other legitimate and acceptable tax bases, but they require their own justification to support a substantial tax. Moreover, limited values will not in and of themselves restrict the level of taxes if the tax rate is unconstrained. Finally, the winners and losers under the limited market value systems in New York, Chicago, and Minnesota demonstrate that assessment caps can have unintended consequences in their redistribution of the tax burden.

Freezes and Thaws

The Florida example shows that while a freeze may be intended to allow seniors to stay in their homes, the revaluation on sale can leave them feeling trapped and unable to move. The Oregon solution of a freeze with no thaw at all, even on a change in ownership, deprives the tax of any necessary connection to market value and, thus, of a claim to fairness or legitimacy on those grounds.

Transparency

Because complex limitation measures diminish the transparency that is one of the inherent strengths of the property tax, it is especially important to mitigate that effect as much as possible. Incorporating some of the notice requirements of truth in taxation legislation may be one step in this direction.

Class Shares of the Tax Burden

There is an initial question as to whether changing class shares of the property tax base constitute a problem. The efforts by New York and Colorado to freeze class shares raise serious equity issues in the distribution of the tax burden. The analysts from the Institute of Government and Public Affairs who studied the Chicago 7 percent limit raised the issue squarely when they wrote that there is "nothing in Illinois tax law or, as we read it, principles of tax policy concerning aggregate tax shares by class." If shifting class shares result in an unreasonable tax burden on individual taxpayers, this should be addressed directly.

The Role for State Oversight

The Massachusetts example shows a long-dormant state apparatus galvanized by court order into active oversight of hundreds of localities. In that case, the DOR was empowered to oversee, implement, and monitor the adoption of a full-value assessment system in every city and town in the state. The success of the resulting completely new system of assessment indicates that sometimes a mandate from another branch or level of government — whether judicial decrees to the state government or state regulation of local systems — can change the political dynamic that may have long impeded reform.

Alternatives

Finally, it is essential to consider alternative measures that may deal directly with the root problem of unacceptable property tax burdens on individual taxpayers. If the problem to be addressed is a property tax out of proportion to cash income, a circuit breaker is one means of addressing it. Circuit breakers limit property taxes as a percentage of personal income in 18 states, but many are underfunded, limited to senior citizens, or subject to such severe income restrictions that they are of little value to the middle class.[58] For example, a West Virginia circuit breaker remains on the books yet is all but forgotten, available only to taxpayers with $5,000 or less in annual income.[59] Although circuit breakers are a central instrument for mitigating property tax burdens, they will not assist homeowners who do not meet their income limits. Even if those limits are generous, that may not resolve the complaints of affluent taxpayers, who often are politically influential. That is one of the lessons of

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[58]*See* Karen Lyons, Sarah Farkas, and Nicholas Johnson, "The Property Tax Circuit Breaker: A Survey of Current Programs," *State Tax Notes*, Apr. 23, 2007, p. 261, *Doc 2007-7898*, or *2007 STT 79-2*.

[59]John H. Bowman, "Circuit Breaker Property Tax Relief in Ohio and West Virginia," *State Tax Notes*, Aug. 6, 2007, p. 389, *Doc 2007-16030*, or *2007 STT 152-5*.

New York City's treatment of condominiums and cooperative units compared with its treatment of rental apartments.

> ***Taxpayer dissatisfaction may and probably does stem from a wide variety of sources, and any one solution is likely to exacerbate some of those or even to create new problems.***

Deferral is another policy that has rarely been tried on a large scale. Traditionally the option to allow taxes to be paid only on sale of the property has been considered unpalatable to senior citizens, who would prefer to bequeath their property without encumbrances. That may be true, but the availability of a deferral option is essential to countering any suggestion that property taxes may have the effect of dispossessing senior citizens of their homes.

Truth in taxation legislation did not counter the support for acquisition-value taxation in Florida. Nonetheless, there is evidence that it can mitigate the temptation for rising values to lead to hidden tax increases if rates are not adjusted correspondingly.[60]

[60]Gary C. Cornia and Lawrence C. Walters, "Full Disclosure: Unanticipated Improvements in Property Tax Uniformity," 25 *Public Budgeting & Finance* 106 (2005).

Like deferral, truth in taxation measures may be necessary but not sufficient alone to maintain a market value assessment base. They could also be important in countering the common view, often repeated in the press, that rising assessed values automatically mean higher property taxes.[61]

Many jurisdictions are facing pressure for new limitations on property taxes. The cases discussed here show the wide range of legislative solutions that may be offered in response. However, taxpayer dissatisfaction may and probably does stem from a wide variety of sources, and any one solution is likely to exacerbate some of those or even to create new problems. Because nearly all limitation measures will have unexpected consequences, it is especially important to learn from the experience of earlier efforts. ✰

[61]For example, within three days *The Wall Street Journal* twice ran statements to this effect:

> "Kauai's real estate prices skyrocketed. . . . With this meteoric rise came a similar rise in property taxes — homeowners here, as elsewhere, pay a percentage of their home's value in annual property taxes." Malia Zimmerman, "This Side of Paradise," *The Wall Street Journal*, Sept. 1-2, 2007, p. A6.
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> "With higher assessments come higher tax bills, something homeowners are learning to their dismay." "Property Tax Flood" (Editorial), *The Wall Street Journal*, Aug. 30, 2007, p. A10.