

## LOCAL GOVERNMENT PROPERTY TAX REVISITED GOOD NEWS AND BAD NEWS

*by Harry A. Green and Stan Chervin*

In February 2002, TACIR released *The Local Property Tax in Tennessee* as part of a series of reports on local government finance. The report presented a lengthy analysis of the local property tax in Tennessee and included detailed sections on:

- The history of the property tax in Tennessee
  - The importance of the property tax to local government finance in Tennessee
  - The historical shift in the distribution of the property tax burden among residential, commercial and industrial, utility, and farm properties
  - The tax elasticity of the property tax in Tennessee counties
  - The stability/volatility behavior of the property tax
  - Equity issues surrounding the property tax
- Local property tax administration
  - Existing disparities in the distribution of per capita property tax bases across counties
  - The outlook for the property tax in local government finance in the 21<sup>st</sup> Century

The purpose of this brief is to update that report using more current information, focusing on four sections:

1. the importance of the local property tax in local government finance,
2. the shift in the distribution of the property tax burden among the various classes of property,
3. the elasticity of the local property tax base versus the elasticity of property tax collections, and
4. the approaching collision between local revenue needs and increasing taxpayer resistance to rising property taxes.

Most of the statistical analysis done in the original report was based on data for the period 1986-1998. This period was dominated by a lengthy economic expansion that began in early 1991 and didn't end until early 2001. The additional data gathered for this update for 1999-2004, covers a period that includes both a short recession in 2001 and the first three years of the current expansion. This additional data should help moderate any bias introduced by the 1990s expansion on the statistical results.

In addition to moderating the impact of the lengthy economic expansion on the analysis, the inclusion of six more years of data increases the number of observations used in various sections of the original report from thirteen years to nineteen years. This expanded time frame improves the reliability of the results.

Major observations noted in this brief include:

- local government dependence on property taxes continues to grow,
- homeowners are shouldering a growing share of the property tax burden in Tennessee,
- the property tax base in a majority of counties remains elastic,
- property tax revenue, as distinct from the property tax base, is not proving to be elastic, and
- the growing property tax burden and growing local government

dependence on the property tax are on a collision course.

This showdown can be avoided or postponed through a combination of an expanded state circuit-breaker program, designed to blunt the impact of rising property tax burdens on a broad-spectrum of low and moderate income households; and a significant increase in state aid to local governments, designed to help them provide a basic level of services to their residents.

## **PROPERTY TAXES MORE IMPORTANT THAN EVER TO LOCAL GOVERNMENT FINANCES**

The original report on the local property tax noted that the property tax, while still the single most important source of revenue for local governments in Tennessee, was a less important source than in the past. A review of the situation using Department of Revenue local option tax collection data for fiscal years 1999 and 2005, and estimated property tax billings for the same two fiscal years, shows local property taxes have increased in importance relative to local option sales taxes. The billings were estimated using local property tax rates and assessments for each local government, including special school districts and other special taxing districts. As shown in Table 1, property tax collections grew 44.5% between 1999 and 2005. This was twice the growth of local option sales taxes, with



property tax revenues accounting for over 72% of the combined total by 2005. Short of an unlikely increase in the authorized maximum local option sales tax rate, now 2.75%, or a dramatic increase in the sales tax base, the property tax will, by default, continue to grow in importance relative to the local option sales tax.

**TABLE 1. COMPARATIVE IMPORTANCE OF PROPERTY TAX VERSUS LOCAL OPTION SALES TAX**

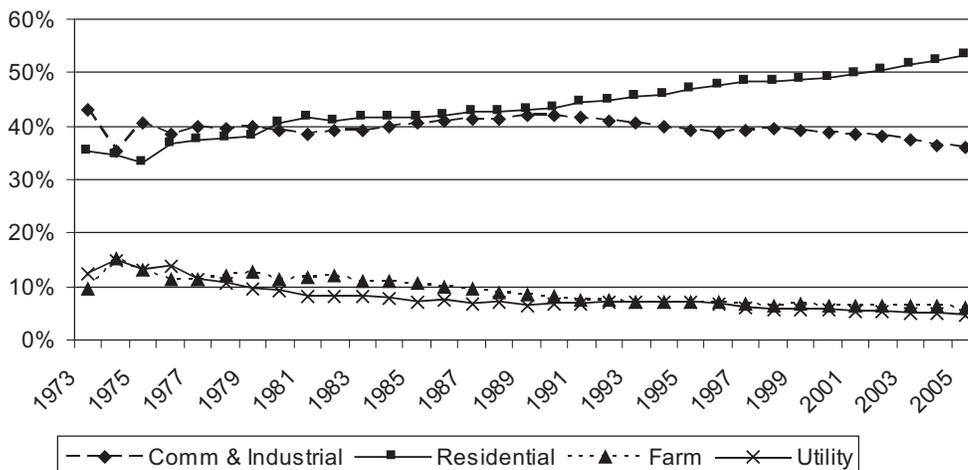
Tax	Fiscal Year		% Change
	1999	2005	
Est. Property Taxes	\$2,986,699,021	\$4,317,186,163	44.5%
Local Option Sales Taxes	\$1,370,629,128	\$1,674,065,036	22.1%
Total	\$4,357,328,149	\$5,991,251,199	37.5%
% Property Tax	68.5%	72.1%	
% Local Option Tax	31.5%	27.9%	

Source: TACIR analysis using Tennessee Department of Revenue and Tennessee Office of the Comptroller data.

## HOMEOWNERS SHOULDERING A GROWING SHARE OF THE PROPERTY TAX BURDEN

Data for the period 1973 through 2000 (as used in the original report) showed a gradual but continuous increase in the residential share of total property tax assessments. Over this period, the residential share of total assessments rose from 35% to almost 50%. Over the same period of time, the commercial and industrial share of total assessments hovered close to 40% while the share for the agriculture and utility class fell to 6.5% and 5.6% respectively.

**FIGURE 1. DISTRIBUTION OF ASSESSMENTS 1973-2005**



Source: TACIR analysis using Tennessee Office of the Comptroller data.



The data for 2001-2005 continue to reflect the same trend identified in the earlier report. By 2005, residential property represented 53.3% of total assessments, commercial and industrial assessments only 35.9% (down 2.7 percentage points since 2000), and agricultural and utility assessments down only slightly (6.1% and 5.6% respectively) from their levels in 2000. The bottom line continues to be that households, whether as owners or renters, are shouldering a growing share of the total property tax burden in Tennessee.

### **PROPERTY TAX BASE IN A MAJORITY OF COUNTIES REMAINS ELASTIC**

Tax elasticity is at best a yawn-provoking topic, often associated with a fog-like glazing over of the eyes on the part of any audience in its general vicinity. It's considered important but too technical for the average layman to want to digest. This is unfortunate. The topic is important enough for the state itself to investigate "elasticity" at regular intervals over the last seventy years. Almost all state tax study committees and commissions have directly or indirectly included this topic in their reports. It is no less an important topic to local governments.

Simply put: in the long run the demand for government services, local and state, increases in step with increases in population and the population's income. This occurs for the same reason that

we observe increases in the demand for most goods and services as population and income increase.

When tax revenue, for whatever reason, doesn't keep pace with the growth in desired levels of public services, the fiscal stress level rises. A common tool used by economists to study the relationship between the growth in tax revenue and personal income over time is tax elasticity. When a tax base over a long period of time is subject to a fixed tax rate and the resulting revenue flow grows at the same rate as personal income, the tax base and its revenue flow are said to have a tax elasticity of 1 (one). Simply put, as population grows over time, a tax with an elasticity of 1 (one) tends to grow at the same rate as personal income; if public services demanded over time also grow at the same rate as personal income, then the tax will produce sufficient revenues to pay for the growing level of public services demanded.

When a tax or combination of taxes do not produce a revenue flow that grows as fast as personal income, the tax elasticity is less than 1 (one) and is described as inelastic. The more inelastic (the lower the calculated number) the tax, and the larger the tax's importance in a government's overall tax structure, the larger the potential long-run problem in financing public services.

The results of the tax elasticity analysis for Tennessee counties show that a majority have elastic property tax bases; total property assessment growth has



outpaced total county personal income. Elasticity calculations using data for nineteen years versus the original thirteen years show the property tax base is elastic for seventy-nine counties. Elasticity measures vary from a low of .289 for Lake County to a high of 2.136 for DeKalb County. The median elasticity was 1.257. The statewide total elasticity was 1.344.

### **PROPERTY TAX REVENUE, AS DISTINCT FROM THE PROPERTY TAX BASE, NOT PROVING TO BE ELASTIC**

A natural response to the previous section would be: “So, where’s the beef?” Why doesn’t an elastic property tax base produce an elastic flow of revenue to the seventy-nine counties found to have elastic property tax bases?

The property tax fails to deliver an elastic revenue flow for several reasons:

1. Tennessee’s “truth in taxation” statutes require very public and open dialogue and documentation of local government property tax rate decisions following property value reappraisals. This requirement in conjunction with (2) and (3) below make it politically difficult to not only raise property tax rates following a reappraisal cycle, but politically difficult to even maintain

the property tax rate that had previously been levied. Despite a clearly elastic property tax base in most counties in the state, actual tax rates in over two-thirds of the ninety-five counties have declined since 1986, reducing the elasticity of the potential revenue stream from the property tax. This situation contrasts sharply with the local option sales tax, which has experienced both tax base growth (in most counties) as well as tax rate increases over time. No counties have reduced their local option sales tax rate since 1986.

2. In Tennessee, the average property tax liability is the single largest tax paid by most households to local governments, easily eclipsing local sales tax liabilities, and for many equaling combined state and local sales liabilities.<sup>1</sup> This fact, in conjunction with the tax most often being collected as a lump sum amount, rather than in small bites as is true of the sales tax, make it a very visible target for dissatisfied property owners.
3. Retired elderly homeowners, many of whom live on fixed incomes and can least afford a growing property tax burden, are growing in number. This is the same group with a record of voting more than any

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<sup>1</sup> Data from “Tax Rates and Tax Burdens, 2004,” a publication of the District of Columbia (August 2005), estimates that families in Memphis (the study compares tax burdens in the largest city in each state) pay more in property taxes than combined state and local sales taxes in each of the income categories studied (\$25,000, \$50,000, \$75,000, \$100,000, and \$150,000).



other age group. In the absence of any serious state program to assist the elderly and other low income homeowners by offsetting rising property tax burdens, local officials will find it even more difficult in the future to take advantage of the underlying elasticity of the property tax base.

## **GROWING PROPERTY TAX BURDEN AND GROWING LOCAL GOVERNMENT DEPENDENCE ON THE PROPERTY TAX ON A COLLISION COURSE**

While becoming increasingly dependent on the property tax for revenue growth, local governments face increasing taxpayer resistance to property tax hikes. The resistance is a combination of perceived and real increases in the burden of property taxes shouldered by homeowners and renters versus the business and utility sector, and the absence of a significant circuit-breaker program in Tennessee.<sup>2</sup>

Many states help blunt the sting of rising property taxes for large numbers of their citizens by offering aggressive circuit-breaker programs available to a broad segment of the tax-paying public. Many programs also offer subsidies for renters who are as affected by rising property taxes as those who own their own homes.

With dependence on the property tax likely to increase, the property tax is headed for a showdown with future taxpayers. This showdown can be avoided, or at least postponed, through a combination of actions:

1. An expanded state circuit-breaker program designed to blunt the impact of rising property tax burdens on a broad-spectrum of low and moderate income households. The state aid should be targeted to phase out as family income rises, but not set so low that moderate income families are excluded from the program.
2. A significant increase in state aid to local governments designed to help them provide a basic level of services to their residents. The aid should go to the level of government that supplies the service (need based), and reflect consideration of both fiscal capacity and fiscal effort.
3. Significant new taxing authority that allows local governments to take advantage of existing tax bases or activities that are currently untaxed. Possible changes include an increase in the local sales tax single article limitation (currently set at \$1,600), the authority to levy payroll taxes, and local ad valorem vehicle taxes in lieu of existing wheel taxes.

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<sup>2</sup> Tennessee's current circuit-breaker program provides limited benefits to very low income elderly, disabled and certain eligible veterans. Total program aid in 2004 amounted to less than \$10 million. Source: Comptroller of the Treasury, Division of Property Assessments, 2005 Annual Report.

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- Monitor the operation of federal-state-local relations,
- Analyze allocation of state and local fiscal resources,
- Analyze the functions of local governments and their fiscal powers,
- Analyze the pattern of local governmental structure and its viability,
- Analyze laws relating to the assessment and taxation of property,
- Publish reports, findings and recommendations, and draft legislation needed to address a particular public policy issue, and
- Provide a neutral forum for discussion and education about critical and sensitive public policy issues.

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