

How to make the property tax system worse

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By Peter S. Fisher

Whenever anyone suggests that you suddenly start doing things in a radically different fashion, you should ask: If this is such a great idea, why hasn't anyone else done it? Such is the case for the proposal to drastically restructure Iowa's property tax system. No longer would your home be taxed on the basis of its current market value. Instead, it would be based on its square footage, and the market value per square foot at the time you purchased your home.

Proponents claim that this system would be more simple and more fair, and would encourage homeowners to improve their homes. In fact, it would be substantially less fair, and the incentives are anti-growth.

First, the incentive issue

Under the current tax system, if you improve your home, its market value increases, the assessed value goes up, and your property taxes go up. Some see this as a penalty for investing in your property. Under the proposed system, if the improvements did not add to square footage, there would be no increased assessment. If you added to the square footage, the additional square feet would be multiplied by the value per square foot at the time you bought the house, not current market value per square foot.

Let's imagine a couple in their 30s or 40s who paid \$90,000 for a "starter home" 10 years ago. Their family has grown, and their income is now much higher. They could make all kinds of improvements to their current home without affecting their tax bill — add central air, remodel the kitchen, add a bathroom, make another bedroom or a family room in the basement. In the process, they could turn it into a \$180,000 house.

Alternatively, they could buy or build a new home. But if they built or bought a comparable \$180,000 home, their property taxes would instantly double, because the valuation of a newly purchased home is its current market value. Thus the proposed tax system is indeed an incentive to fix up your existing home, but it is also a powerful incentive not to move or build a new one.

Now consider a family in a neighborhood that has been on the decline. The home they bought 10 years ago for \$90,000 is now worth only \$70,000 but they are still paying taxes based on \$90,000. The only way they can lower their taxes without moving is to sell to someone else and rent it back. Homeowners in declining neighborhoods have an economic incentive to turn themselves into renters or move away, hardly what is needed in such places to stabilize the neighborhood.

What about a newly retired couple, empty nesters, who find themselves in a four-bedroom home built 15 years ago for a family of five for a cost of \$150,000. It is now worth \$250,000 (but still taxed as if it were \$150,000). They want to cut down on their costs and move to a smaller home. But given the inflation in housing prices over 15 years, the smaller homes they are looking at now cost \$180,000. Moving to a smaller home would increase their property tax bill.

The tax proposal, in other words, contains powerful incentives for people to remain where they are. Retired couples stay in larger homes than they need instead of freeing them up for the next generation of families. Growing families add bedrooms in the basement instead of building new homes. The home building industry, and all those that depend on it directly or indirectly for a living, suffer.

What about fairness?

Consider two households living in \$150,000 homes (actual market value). They have the same incomes, the same family size, send their children to the same schools. One just bought the home and pays taxes on \$150,000 in value; the other bought it 15 years ago at half the price and pays half the taxes. Tax bills under the proposed plan, in other words, would become less related to ability-to-pay, and instead would largely depend on how long you have lived at the same address. Tell me again, why is this more fair than what we have now?

What this bill really accomplishes is to shift tax burdens around: from long-time residents to new arrivals (hardly a way to attract labor to a state facing labor shortages), and from stable households to changing households (what a way to help young families!). Some might argue that ways can be found to avoid the perverse incentives and inequities the system contains. But attempts to do this will undoubtedly transform a simple proposal into a system more complex than what we have now. The fact is, market value is a simple, objective standard. While there are certainly problems with the current system, abandoning market value as the starting point in the assessment process does not help.

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