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Restoring Home Ownership as Part of the American Dream

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Introduction

A new property tax revolt is sweeping the country, not unlike the first property tax revolt launched by Proposition 13 in California in 1978. Many homeowners have seen their property taxes skyrocket in recent years. Homeowners are challenging inflationary increases in their property taxes both through their state legislatures and at the ballot box. In some states citizens are demanding not just reform but rather elimination of property taxes. Other proposed reforms address the concerns of homeowners, while retaining property taxes as an important part of the tax system. This study explores the reasons for the new property tax revolt and evaluates proposed reforms in property taxation.

Home Ownership and Property Taxation

Homeownership has been part of the American dream of prosperity for centuries, but for many citizens and especially younger generations that dream is disappearing. Historically home ownership has been the most important investment that most citizens make over their lifetime. Investment in financial assets is a growing share of wealth, but for most citizens the investment in their home is their major source of wealth.

Home ownership creates an automatic savings and investment vehicle. Homeowners take out a mortgage requiring monthly payments of principal and interest. Building up equity in a home and paying off the mortgage over their lifetime allows citizens to provide for their retirement and in some cases an inheritance for their families. The equity in their home could be used to help meet the needs of their family for education, health care, and emergency expenditures. Paying off one's mortgage was a lifetime achievement signaling that citizens met their financial obligations.

All the decisions that citizens make by investing in a home are distorted by inflation. The double-digit inflation rates experienced in recent years magnify those distortions. The new property tax revolt, like the first property tax revolt in the 1970s, is a rationale response to the failure of the federal government to stabilize prices.

On the one hand homeowners benefit from increases in the value of their homes in inflationary periods. But until they sell their home these are unrealized capital gains, and in most states homeowners must pay increasing property taxes on these unrealized capital gains. Inflation not only increases property taxes, but it also increases interest rates and other costs of home ownership. If citizens can't pay the higher property taxes and other costs of home ownership the only alternative to bankruptcy is to sell the home.

The high rates of inflation in recent years have been pricing many citizens out of the housing market. Inflation not only increases the cost of home ownership it is usually accompanied by higher rents. This has led to intergenerational conflict. Younger generations cannot afford either higher rents, or the higher prices for homes and the increased cost of homeownership. The increased average age of first-time home buyers is a symptom of this intergenerational conflict.

Restoring the Dream of Home Ownership

Inflation increases the risk and uncertainty of investing in a home. Investing in a home is like entering into an incomplete contract; the homeowner does not know what the impact of inflation will be on her property taxes. The challenge for homeowners is how to protect themselves from inflationary increases in their property taxes.

One approach that has been proposed in several state legislatures this year is to eliminate the property tax entirely. But there is an alternative approach that addresses the problem of inflationary incases in property taxes while retaining property taxes as an important part of the tax system.

When inflation increases the assessed value of a home and property taxes, this is a tax on unrealized capital gains. Capital gains on a home could be treated the same way that we treat unrealized capital gains in a retirement account. When citizens invest in a retirement account they may receive unrealized capital gains on their investments. If the assets remain in the retirement account the taxes on these unrealized are deferred. Only if the assets in the retirement account are sold is the investor subject to taxes on the capital gains.

One of the most important benefits of investing in a retirement account is the step-up basis used to value the assets. When the investor dies the value of assets in the account are increased to market value for the heirs. Heirs may also take advantage of the deferred taxes on the capital gains in assets they inherit although there are restrictions on how they do this. It is not surprising that this step-up basis is a major incentive for individuals to invest in retirement accounts, especially if they anticipate passing wealth along to their heirs.

Investment in a home could be treated for tax purposes the same way that we treat investments in assets in a retirement account. In this approach the assessed value of the home is set at market value when the home is purchased. The assessed value is not increased as long as the individual owns the home. Property taxes are equal to the millage rate times the assessed value of the home. Elected officials determine the millage rate and the assessment rate, i.e., the percentage of the assessed value subject to property taxation. Thus, property taxes may increase due to increases in the millage rate or the assessment rate. But elected officials have no control over the assessed value of the home, that remains constant as long as the owner retains ownership. The market value of the home may increase due to inflation, but inflation has no impact on assessed value or property taxes. Individuals investing in a home have a more complete contract knowing that the assessed value of the home remains constant as long as they retain ownership.

If the homeowner sells the house, she will pay capital gains taxes on the increased value of the home. The market value would then set a new assessment value for the home buyer. Under current law homeowners can defer taxes on the capital gains from the sale of the home by rolling the proceeds into investment in like kind of property. In this way a homeowner can defer paying capital gains on the home over a longer period. Under current law when a home is inherited the value of the home is stepped up to market value for heirs. Heirs can benefit from deferring the capital gains on the home as well.

By fixing the assessed value of a home at the market value when the home is purchased, paying taxes on the unrealized capital gains in the home is deferred in the same way that capital gains taxes on assets in a retirement account are deferred. If the home is passed along to heirs, the taxes on unrealized capital gains can be deferred over a longer period. This reform would significantly increase opportunities and incentives for citizens to invest in a home. It would also make it easier for younger generations to purchase a home and help to reduce intergenerational conflicts.

Proposition 13: A Critique

The precedent for the property tax reform proposed in this study is Proposition 13, an amendment passed through the initiative process in California in 1978. California's Prop 13 caps the increase in assessed value of a home to the lesser of the free market value, or the previous year's value plus the lesser of two and a half percent, or the percentage change in the Consumer Price Index. The millage rate is capped at the level in place when the property tax limit is enacted. Voter approval is required for any increase in the millage rate.

California's Prop 13 has saved individual homeowners in California from inflationary increases in their property taxes. Polls show that citizens in California continue to support Prop 13 despite many attempts to weaken or eliminate it. Similar property tax limits have been enacted in other states as well.

The major criticism of Proposition 13 is that it allows local governments to tax a portion of the unrealized capital gains in a home. Under Proposition 13 the assessed value of a home can increase up to the 21/2 % cap. But there is no reason why homeowners should have to pay property taxes on the unrealized capital gains in their home. Local governments should be prohibited from imposing any property taxes on unrealized capital gains in a home as long as the homeowner remains in the home. Unrealized capital gains in a home should be treated in the same way that unrealized capital gains on assets in a retirement account are treated for tax purposes.

The logic of this approach is clear when we pose a counterfactual hypothesis. What if politicians decided that the unrealized capital gains on assets in a retirement account should be taxed. The negative impact of such a decision on citizens investing in retirement accounts would certainly lead to vigorous opposition and a tax revolt beyond anything we are currently experiencing. It is difficult to believe that such a tax proposal would be approved in the face of a tax revolt.

Today citizens are revolting against burdensome property taxes on their homes. If given the option of voting on a ballot measure eliminating property taxes on unrealized capital gains in their homes the expectation is that such a measure would receive overwhelming support. The popularity of Roth retirement accounts is a measure of support for tax laws that allow investors to defer taxes on unrealized capital gains on their retirement investments. The property tax reform proposed in this study would treat investment in a home the same as investment in a retirement account for tax purposes.

Eliminating the taxation of unrealized capital gains in a home would make investment in a home as attractive as investing in assets in a retirement account. This would eliminate a bias in property tax law that allows for taxation of unrealized capital gains in a home. In effect the reform proposed in this study would open up home ownership to a wider range of citizens including younger generations. The reform would be especially important for citizens who invest in a home for retirement, putting investing in a home on equal footing with investing in a retirement account.

Restoring Property Taxes as an Important Part of the Tax System

In the new property tax revolt, some citizens and elected officials are demanding elimination of property taxes entirely. The reform of property taxes proposed in this study would address some of their concerns and also help to restore property taxes as an important part of the tax system.

Much of the criticism of property taxes comes from local governments and interest groups who claim that property taxes provide an inadequate source of revenue to fund local services. This criticism is often leveled against property taxes by school districts and teachers' unions. This is not surprising since property taxes fund a major share of funding for education K-12. This has been a major source of criticism of Proposition 13 in California. Critics point to inequities that result from differences in property taxes paid by homeowners who are benefiting from Proposition 13 and new home buyers who must pay property taxes on the market value of their homes. But this ignores the fact that proposition 13 has increased the value of all homes. While there may be inequities in the short term, in the long term all homeowners benefit from the cap on assessed value and the increase in home values resulting from this protection. Recent studies show that proposition

13 has not reduced the total assessed value of homes in California because properties when sold are worth more because Proposition 13 protects homeowners from inflationary increases in property taxes.

Critics claim that homeowners who do not have children in school do not benefit directly from these expenditures and as a result often vote down ballot measures proposing increased taxes for schools. That claim is not entirely true. All homeowners benefit from improvements in the quality of schools because that increases their property values. In states such as Colorado, ballot measures proposing increased taxes to fund schools pass at a much higher rate than other ballot measures.

Property taxes have also resulted in intergenerational conflicts over taxation. State and local governments have created incentives for home ownership for certain targeted groups using so-called circuit brakers, e.g. homestead exemptions, property tax rebates etc. Such targeted tax breaks are often linked to age, income, veteran status etc. The property tax reform proposed in this study would benefit all homeowners not just targeted groups. The best way to incentivize citizens to purchase a home is to provide property tax relief that benefits all homeowners.

Property taxes are the basis for a strong federalist system. They provide local governments with a source of revenue independent from state and national governments. Property taxes provide for transparency and accountability in how their tax dollars are spent at the local level, which is often lacking at the state and federal level. Over the years local governments have become more dependent on state and federal revenues to fund their services, including education. The expanded role for state and federal government in funding local government services is weakening our federalist system. The property tax reform proposed in this study would strengthen the tax system and help to restore the role of local governments in a strong federalist system.

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