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Idea

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Enact a property tax circuit breaker

Each Southern state should consider enacting a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*.

Background

Property tax reform is an increasingly hot topic in legislatures across the South. The 2006 legislative session included proposals to replace property taxes with an increased sales tax (South Carolina), enact a property assessment cap (Georgia) and make property tax exemptions portable for homeowners who move (Florida).

No Southern state offers a property tax circuit breaker, which is a *progressive* solution to excessive property taxation.

The arguments supporting property tax breaks often are compelling, such as accounts of fixed-income elderly ho-

meowners being taxed out of their homes and neighborhoods. While the need for relief is sometimes warranted, legislators frequently seek solutions that are poor tax policy, such as assessment caps, freezes and other methods that provide broad-based tax cuts regardless of need or income.

The use of property tax restrictions and breaks is widespread. Many states have layers of programs. But none of the eleven Southern states have a property tax circuit breaker, a tool that offers a progressive solution to excessive property taxation. The property tax circuit breaker instills a measure of *ability-to-pay* into the property tax system because it limits property taxes to a certain percent of income. For example, if a homeowner's property tax bill goes over 3 percent of his income, then he is "overloaded" by property taxes and the circuit breaker kicks in to refund a portion of his tax payment. While property taxes are predominantly local, the circuit breaker is a way for states to ensure property taxes stay at a reasonable level of income.

Many reform options, many policy pitfalls

Property taxes in most Southern states are low relative to the rest of the nation, as highlighted in Figure 1 below. Except for Florida and Virginia, all Southern states rank in the bottom half of states for property taxes per capita and as a percent of personal income. In spite of those low rankings, property taxes have become the most hated tax in many states due in part to the visibility of the tax and the disconnect between property taxes and income.

In contrast to sales taxes, which accumulate through pennies on the dollar every time somebody buys something,

property taxes are a visible tax. Homeowners know the cumulative property tax bill every year when the annual bill arrives. In part because they see the impact in one big chunk, taxpayers often resist the property tax even if their annual property taxes take a lower share of income than other taxes.

While the visibility of the property tax is not necessarily grounds for tax relief, there's a second concern—the disconnect between property taxes and income. Because of the way the system is set up, property taxes are tied to a property's value, not the income of a property owner.

Figure 1: State and local property tax rankings in Southern states, 2002

State	Property taxes per capita	Rank	Property taxes as % of personal income	Rank
United States	*$992*		*3.1%*	
Alabama	$331	51	1.3%	51
Arkansas	$375	50	1.6%	49
Florida	$986	18	3.2%	22
Georgia	$811	35	2.7%	35
Kentucky	$489	46	1.9%	44
Louisiana	$434	47	1.7%	45
Mississippi	$579	42	2.6%	37
North Carolina	$674	39	2.4%	41
South Carolina	$772	36	3.0%	27
Tennessee	$607	41	2.2%	42
Virginia	$948	24	2.8%	32

Sources: National Conference of State Legislatures[1]
Note: Rankings include 50 states and the District of Columbia. The most current available census data on state and local finances is for 2002.

This "disconnect" deserves policy attention because it can create unfair tax burdens. For example, a homeowner's property taxes can increase substantially because home values increase even though the homeowner's income might stay the same or fall.

Hating the property tax isn't necessarily rational, but understandable since the impact arrives once a year instead of cumulatively like the sales tax does every time you buy something.

In an attempt to alleviate these concerns, states use a variety of property tax programs and restrictions to lessen the property tax obligation. Legislators attempt to either restrict the growth in taxes through limits, caps and freezes, or provide relief through homestead exemptions, credits and deferrals (Figure 2). While these programs offer some benefits to residents in need, they often do not recognize *ability-to-pay* (i.e. income), which creates many unintended beneficiaries.

Restrictive Measures: Limits, caps and freezes

Property tax limits provide broad-based tax relief, which can create long-term inequities and tax shifts. These restrictive measures come in many forms, including revenue limits, assessment caps and tax freezes, and are used varyingly across the South. As shown in Figure 2, property tax rate limits are the most common. An example of a tax rate limit is North Carolina's $1.50 per $100 of appraised property value. Thus, local jurisdictions can only tax at a rate at or below $1.50 per $100 of value. Often these rate limits can be changed through voter approval.

Another tax restriction is a property assessment cap, which is currently used in Florida and Arkansas. In Florida, property assessments can only increase annually by 3 percent or inflation, whichever is less. The property is reassessed at its true value (or fair market value) only when a home is sold or improved. Under such assessment caps, two similar houses might have significantly different property tax bills because of the length of ownership. Longtime homeowners would enjoy lower property taxes than new homeowners even though they owned similar property. Such caps shift the tax burden among residents and provide tax breaks regardless of income.

While assessment caps make the tax less fair, they do not necessarily restrict the amount of property taxes collected. Local governments can still raise additional revenue by increasing the millage rate. In contrast, property tax revenue limits restrict the total amount of revenue a jurisdiction is allowed to collect. Revenue limits can threaten the *adequacy* of funds and create inflexibility within government such that it cannot raise new property taxes to meet additional service demands.

Relief Measures: Exemptions, credits and deferrals

Homestead exemptions, credits and deferrals are relief programs offered in numerous states, also as shown in Figure 2. Homestead exemptions remove a certain amount of a home's assessed value from taxation. Several states offer homestead exemptions to all homeowners and more generous exemptions to elderly or disabled homeowners. In Alabama, for example, the first $4,000 of assessed value is exempted from state taxation. Elderly

homeowners, however, receive an additional exemption which eliminates all state property taxes for those aged 65 and over. Homestead credits, which are similar, are a defined amount that the state exempts from the property tax bill. In Arkansas, the state pays the first $300 of the property tax bill.

Tax deferrals are available in four Southern states, mainly to elderly and disabled homeowners. Through this tool, property owners defer property tax payments until they sell a home or they die. Through deferrals, state and local governments allow the fixed-income homeowner to pay when money is available. According to surveys by the AARP, tax deferral programs are the least used property tax relief program by those who are eligible.[2]

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While these programs do not have the policy pitfalls of the caps, freezes and limits, they also do not always take income into account. They generally offer broad tax breaks to all homeowners without fully addressing the income limitations of some homeowners. These relief measures can leave some low- and moderate-income homeowners as well as renters with pressure that stems from the property tax system, which fluctuates with property values rather than income.

Figure 2: Property tax restrictions and relief programs						
State	Rate limits	Revenue limits	Assessment caps	Homestead exemption and credit	Tax deferral	Circuit breaker
Alabama	X			X		
Arkansas	X	X	X	X		
Florida	X		X	X	X	
Georgia	X			X	X	
Kentucky	X	X		X		
Louisiana	X	X		X		
Mississippi		X		X		
North Carolina	X			X		
South Carolina	X			X		
Tennessee				X	X	
Virginia				X	X	

Source: Baer, David. *State Programs & Practices for Reducing Residential Property Tax*[3]
Note: The above list includes major programs. Certain states allow local jurisdictions to enact limits, which are not necessarily included in this analysis.

A progressive approach to property taxes

A progressive alternative to the options discussed above is a property tax "circuit breaker." As of 2005, thirty-five states and the District of Columbia had some form of circuit breaker program.[4] In spite of its popularity, none of the eleven Southern states have circuit breaker programs.[5] (In 2006, a South Carolina Senate subcommittee proposed a property tax circuit breaker during long debate on property tax reform, but the measure failed to make it out of committee.)

Caps, limits and freezes weaken the property tax system in terms of *fairness* and *adequacy*. In other words, these restrictive measures can cause unevenness between taxpay-

ers and can put stress on the tax system if they provide less money than needed. Likewise, homestead exemptions and credits suffer from being poorly targeted. Often, exemptions and credits are spread across all homeowners, rather than providing greater tax breaks to those homeowners and renters with a limited *ability-to-pay*. In contrast, circuit breakers can increase the fairness of the tax system and offer targeted relief to homeowners and renters in need. Circuit breakers accomplish this targeted, fair relief by restricting property taxes to a certain amount of income. When taxes exceed that amount of income and the taxpayer is "overloaded," the excess tax is refunded or credited through the income tax system.

Property tax circuit breakers can increase *fairness* of the tax system and provide targeted, *progressive* relief.

Circuit breaker programs vary widely. Some programs target seniors or low-income homeowners only, while others also target a broader spectrum of moderate-income residents. Several circuit breaker programs also include renters, since they pay property taxes that are incorporated into rent prices. Circuit breakers are designed to phase out as income increases and to stop entirely when income reaches a certain threshold. For example, Wisconsin's circuit breaker phases out by $24,500 in income, while Michigan and New Jersey have more generous thresholds of $82,000 and $200,000, respectively.

Maryland is in the process of updating its 1975 circuit breaker program and offers a good example of how the program works. Under the new guidelines, the first $8,000 of income would have a circuit breaker of 0 percent.[6] So

if a taxpayer has an income below $8,000, then any property tax liability is considered excessive and the circuit breaker program refunds the property tax payment. The circuit breaker increases from 0 percent to 4 percent for income between $8,000 and $12,000. This is a marginal increase—meaning, the first $8,000 still is not taxed, while the next $4,000 in income is subject to a 4 percent circuit breaker. The percent of income allowable in property taxes continues to rise to 6.5 percent of income from $12,000 to $16,000 and 9.0 percent of income from $16,000 to $60,000. The circuit breaker program does not apply to taxpayers with incomes of more than $60,000 or assets over a certain limitation.

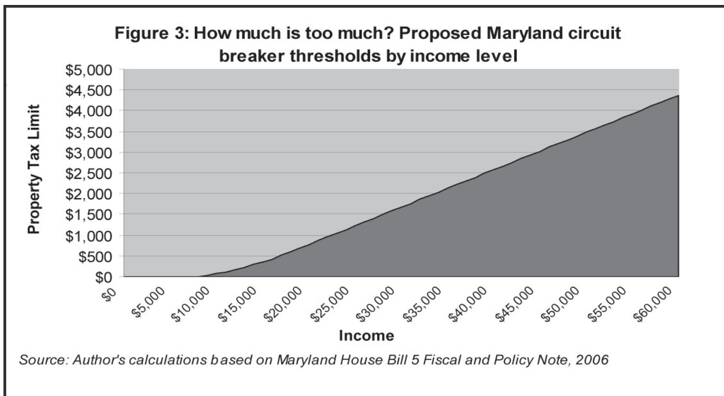

Figure 3: How much is too much? Proposed Maryland circuit breaker thresholds by income level

Source: Author's calculations based on Maryland House Bill 5 Fiscal and Policy Note, 2006

As illustrated in Figure 3, the amount of property taxes that residents should be able to afford increases with income, which means the circuit breaker program has a progressive impact. For a Maryland taxpayer with $15,000 in income, the circuit breaker takes effect at around $350 in property taxes. If the taxpayer's bill exceeds $350, the taxpayer is considered to be "overloaded" and the circuit breaker kicks in to relieve the tax obligation. For a taxpayer with $40,000 of income, that circuit breaker begins at around $2,500 in annual property taxes.

Although property taxes primarily are a local tax, the circuit breaker should be considered in this discussion since states bear the cost of circuit break programs. When a taxpayer qualifies for the circuit breaker, the state rebates or credits the excessive taxes through the income tax system. The cost of a circuit breaker program in Southern states would vary depending on several factors:

- **Tax threshold.** The *tax threshold* is the point at which the circuit breaker kicks in. If the circuit breaker begins when taxes exceed 5 percent of income, then only residents who pay over 5 percent of income in property taxes will be eligible. If the circuit breaker kicks in at 3 percent of income, then more people will qualify and the cost of the program to the state will be greater.

- **Income limit.** The income limit is the point at which the circuit breaker program ends. In the Maryland example above, the limit is $60,000. Households with income over $60,000 do not qualify for the program. The cost of the program increases as the income limit increases because more residents become eligible. If the income limit is low, then fewer residents will qualify and the cost of the program will be less. In contrast, if Southern states set a high income limit, such as New Jersey's $200,000, the cost will be much greater.

- **Type of household.** States include different populations in their circuit breaker programs—homeowners, renters, elderly, disabled, low-income, moderate-income and others. Southern states would need to decide on the target population and consider that programs should be based on need rather than age

alone. The more people included in the program, the greater the cost of the circuit breaker to a state.

- **Refund limit.** States do not provide the full amount of excess tax back to the homeowner or renter. In Minnesota, for example, the maximum refund is $1,690. The level of the credit, or the refund available, is another component driving the cost of the program.

A tool that can work

Southern states currently have several programs to lower property taxes, such as homestead exemptions, tax deferrals and revenue and assessment limits. But no Southern state has a circuit breaker program, which can have a progressive effect on property taxes.

If Southern residents need property tax relief, as many legislators argue, then a circuit breaker should be created to restrict property taxes to a certain percentage of income for residents in need. Legislators rightly fear that *ability-to-pay* is not always part of the current property tax system. Enacting a circuit breaker would infuse an ability-to-pay measure into property taxes. In turn, taxpayers would know what the state thinks is too much for them to pay.

Talking points

- Southern policymakers are under increasing pressure to provide property tax relief.

- Current solutions to property tax relief are inadequate and unfair because they cause budget stresses that aren't sound fiscal policy or they are not targeted to people in need.

- A way to provide property tax relief to people who need it is to base such relief on how much they can pay.

- A property tax circuit breaker is a flexible tool that can be used to provide relief to people who need it—those with low incomes or elderly people on fixed incomes.

- It's a smart way to provide relief because it is means-tested.

Endnotes

[1] *Ranking of State-Local Revenue and Expenditure Data.* National Conference of State Legislatures. *www.ncsl.org/programs/fiscal/cb02proptrank.htm.*
[2] Baer, David. *State Programs and Practices for Reducing Residential Property Taxes.* May 2003. AARP. *http://www.aarp.org/ppi.*
[3] Baer (2003); Baer , David. *State Programs and Practices for Reducing Residential Property Taxes.* October 6, 2005. AARP. *http://ppa.boisestate.edu/centerppa/documents/20051006pm0315-baer.pdf.*
[4] Baer (2005).
[5] Florida has a program somewhat similar to a circuit breaker in that it is activated when property taxes exceed a certain level of income. In contrast to true circuit breaker programs, Florida's program is a deferral program that requires taxpayers to pay the excess tax in later years. In addition, Arkansas had a circuit breaker program, but replaced it with a homestead credit program.
[6] Sanelli, Michael. *Fiscal and Policy Note to House Bill 5: Revised.* Maryland General Assembly, Department of Legislative Services. 2006 Session.