Property Tax Circuit-breakers: Good Causes but Bad Economics

By WILLIAM T. HARRIS*

ABSTRACT. Since 1965, 30 states and the District of Columbia have enacted programs designed to reduce the effective rate of *property taxation* for some *low income households* and for the *elderly*. Most often this relief is provided by so-called *"circuit-breakers."* It is contended that the economic arguments favoring circuit-breakers are empirically unproven and theoretically suspect. The *tax* may be *progressive*, not *regressive*, and the device may transfer income from low to high income households. Any short run *redistribution of income* to favor the *poor* or the elderly would, in the long run, merely shift the timing of their tax payments. Circuit-breakers encourage over-consumption of housing and *misallocation of housing resources*. Reducing the tax base, they produce higher rates and so increase the *tax burden*.

I
Introduction

IN 1967, the Advisory Commission on Intergovernmental Relations (ACIR) officially went on record in support of property tax relief for low income families.[1] Six years later the Commission reaffirmed its 1967 position that state governments should assure low income households that property taxation would not become excessive in relation to current income.[2] To date, 30 states and the District of Columbia have enacted programs designed to reduce the effective rate of property taxation for some low income families and the elderly. The so-called circuit-breaker has become the approach most often used to provide this relief. The purpose of this paper is to investigate the argument that circuit-breakers are inefficient devices for allocating income and that the economic arguments favoring them are unsubstantiated and largely invalid.

II
Property Taxation and Circuit-Breakers

OVER THE PAST one hundred years, professional and popular opinion con-

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cerning property taxation has undergone a complete reversal. Most notably, Henry George argued persuasively for a "single tax" on land values as an unearned surplus (*i.e.*, Ricardian land rents) as the most equitable and desirable form of taxation.[3] In response to the rapid increase in local property taxes during the past three decades, others have advocated equally strongly that reliance upon this important source of local government revenue be reduced. Although Henry George created a significant interest in tax reform, the issue of property tax reform did not become a serious question of public policy until the 1960s and early 1970s.

Property tax burdens began to rise substantially during the 1950s and 1960s when urbanization and the "baby boom" exerted unusual pressure on local governments to provide and finance additional local public services—especially elementary and secondary education. Such unanticipated increases in local expenditures necessarily required more intensive use of local governments' primary revenue sources. Not surprisingly, higher local property tax bills were soon to follow.

The absolute increase in homeowners' tax liabilities caused by increased local government spending and rapidly appreciating real estate values was viewed by some as overburdening the low incomes of the poor and the fixed incomes of the elderly. May and Zaki, for example, presented the typical argument: ". . . it is generally held by the American public that the property tax is excessive and growing at an unacceptably high rate and that it places an unfair and in many instances an intolerable financial burden on low-income individuals, particularly the handicapped and the aged."[4]

The central feature of most circuit-breaker programs is that tax relief varies inversely with household income.[5] Under a circuit-breaker system, a credit is given to the low income or elderly taxpayer. In many instances, the credit is granted as a decrease in state income taxes. Some programs provide a cash refund to households with state income tax liabilities less than the amount of the credit. Still other states grant cash refunds to all eligible families, while some provide relief in the form of reduced property tax bills. About 20 of the 30 states with some form of circuit-breaker allow credits for tenants as well as homeowners.[6]

The ultimate long-run effect of circuit-breaker type property tax relief for the elderly is to shift the timing of one's tax liability from later in life to earlier years. In other words, assuming that a state's circuit-breakers do not result in a decrease in overall property tax levels, over a 45-year period, such relief means, on average, households will pay higher taxes earlier in life to offset the reduced taxes paid after age 65. The reduction in the tax liability of the elderly, obviously, must increase correspondingly the tax liability of the younger taxpayers.

III

The Case For (and Against) Selective Property Tax Relief

SUPPORT FOR THESE CIRCUIT-BREAKERS is based usually upon three economic arguments: 1) circuit-breakers generate external benefits such as neighborhood stability by facilitating homeownership; 2) selective relief for the aged is a form of rational forced saving and self-insurance; and 3) the property tax is regressive.

1. *Do circuit-breakers generate positive externalities?* Some contend that property tax relief for low income families (and especially for the elderly) allows them to remain in their present homes longer than otherwise and hence encourages homeownership. In the absence of relief, households that cannot afford to pay the tax are forced to sell their houses and to move into more affordable (*i.e.*, less expensive and hence less attractive) dwellings. Ladd, for instance, argued ". . . that there are social as well as private benefits from homeownership, such as the encouragement of a more stable society, [and hence] not all this (favorable tax treatment of housing) would be considered a misallocation of resources."[7] Bowman presented a similar case: "Circuit-breakers, by permitting low-income elderly—and non-elderly with temporarily depressed incomes—to remain in their homes in spite of a fall in income, contribute to the attainment of such social objectives as stability and homeownership."[8] In a somewhat different context, Thomassen defended circuit-breakers on the externality argument. In his analysis, households headed by the aged are, for various reasons, spatially immobile and, when faced with unexpected increases in their property tax and home maintenance costs, neglect upkeep and overuse the premises and so cause neighborhood decay.[9]

These externality arguments are specious, empirically unsubstantiated, and, therefore, irrelevant. Housing sales "forced" by excessive property taxation do not necessarily reduce homeownership. There is no *a priori* reason to conclude that the new owners are not going to occupy the premises. Simply put, circuit-breakers may reduce housing turnover, but they do not necessarily reduce owner-occupancy rates. In fact, the new buyers may very well be younger renters who are more able to afford current and future tax bills. If the new owners are younger, they may reduce turnover in the long-run by remaining in the premises longer because they are statistically more likely to outlive the older, previous owners. Those who do sell because of high absolute tax levels, moreover, may become owner-occupants in other areas, and of dwellings better suited to their present needs. This case for circuit-breakers is theoretically uncertain and empirically undocumented.

Finally, it seems unlikely that even if property taxes are reduced for low income families, the recipients will spend the property tax reduction on externally beneficial repairs. Many of the very poor can be expected to increase current consumption. For the very old, the private benefits from such maintenance expenditures may outlive the occupant and hence not be undertaken.

2. *Do circuit-breakers represent a rational, constitutional decision to force self-insurance and saving?*[10] Those familiar with the public choice analysis of Buchanan and Tullock will recognize the social insurance nature of this argument.[11] Although their approach explains the public demand for such coerced transfers from an individualistic, utility maximizing perspective, there are convincing arguments to suggest that such public programs do not promote economic efficiency and are subject to intergovernmental exploitation.[12] Such forced saving and self-insurance arguments justify at best the gradual phasing-in of relief, but not the granting of windfall redistribution in favor of the present generation of elderly.

3. *Is the property tax regressive?* The issue of property tax regressivity is most often cited as a justification for circuit-breakers. In its simplest form, many believe that any tax which is regressive is "bad"; consequently, there exists a *prima facie* need for reform (*i.e.*, the tax should be made less regressive or altered to become progressive). Consider the following analysis by ACIR: "In 1970, the average homeowner with an income of approximately $10,000 turned over $340 (3.4 percent of his total money income) to the residential property tax collector. In striking contrast, over 6 million elderly homeowners paid an average of 5.2 percent of their income in property taxes. The property tax collector took an average 16.6 percent of household income from all 1.7 million homeowners with incomes less than $2,000."[13] As a result of these and other similar findings, the Commission recommended "that states shield basic family income from undue burdens imposed by the property tax."[14]

There are three basic reasons to reject the regressivity arguments which favor circuit-breakers: 1) tax regressivity is not, in and of itself, a sufficient objection; 2) the property tax may, in fact, be a progressive tax; and 3) even if property taxes are completely shifted forward and hence an excise tax, they are substantially less regressive than one is initially led to believe.

Although compassion and other prejudices lead many to abhor regressive taxation, efficiency and equity considerations destroy such arbitrary reasons for advocating only progressive tax structures.[15] Buchanan and others have made it unambiguously clear that a fiscal system's redistributive effects include both tax and expenditure considerations.[16] Simply stated, the existence of regressivity is neither a sufficient nor a necessary condition for "reforming" the tax structure. This attack upon property taxation is, however, least important.

Recent developments in property tax incidence theory generally have weakened the traditional analysis which suggests regressivity and this case for circuit-breakers. The "traditional view" of the incidence of the property tax holds that it is an excise tax on housing consumption. This is so because owners of property are able to pass property taxes forward and to include them in the prices of final consumption goods. According to the "traditional view" of the property tax, if the income elasticity of housing demand is less than unity, then a proportionate tax on housing must be regressive. This view that the property tax is an excise tax on occupancy rights is endorsed by Netzer, ACIR, and Richard and Peggy Musgrave.[17]

Another view of the incidence of the property tax is that the owners of capital would bear the full burden of the tax because it is fully shifted backward to capital suppliers. When this occurs, owners of capital receive lower earnings than otherwise. If owners of capital bear the entire burden, then the incidence will be progressive because capital income is a larger proportion of total income in higher income classes.[18]

A third view, the so-called "new view", has been advanced. It attempts to reconcile the two positions mentioned above.[19] In an economy such as ours with a multitude of local property taxing jurisdictions, the incidence of the tax depends on whether we are looking at the overall effects for the nation as a whole or at the effects within a particular locality. On a national basis, capital owners bear the burden because positive and negative price effects cancel out. In other words, higher prices in localities with above average tax rates offset the lower prices in localities with below average tax rates, thereby leaving the overall price level unchanged. "If the aggregate effect on consumers in all areas is considered, there is no net burden (on consumers)—some lose but others gain. Owners of capital bear the full burden of the property tax taken all together."[20]

On the other hand, if we consider the effects within a single locality, the burden of a property tax increase will fall on consumers within the particular jurisdiction in the form of higher prices.[21] In either case, acceptance of the "other view" or the "new view" of the incidence of the property tax seriously undermines the need for circuit-breakers based upon the "traditional view" that the tax is regressive.

For those who reject the "other" and "new" views and assume property taxes are fully shifted forward to housing consumers, further consideration suggests that the regressivity of the tax is far less than reported. Browning, for example, has demonstrated cogently that when income received from transfers is taken into account, even excise taxes are borne ultimately in proportion to household income and hence are not regressive.[22]

Conventional measures of the tax rate structure calculate property tax burdens simply as the ratio of property tax payments to current annual money income. This measure is woefully inadequate because most estimates use as an income measure only money income, when real economic income also includes the value of in-kind transfers and the market value of household-owned and employed capital.[23] In other words, income in its broadest sense includes the cash equivalent of private and government in-kind transfers (and subsidies) plus the value of household durables consumed in a given year. Although some households (and especially among the elderly) have low reported money incomes, their real economic incomes are usually significantly greater. Consider, for example, a retired couple with the following sources of income: 1) a house currently worth $65,000; hence approximately $5,000 of annual implicit rental income; 2) government in-kind transfers (e.g., Medicare, food stamps, housing assistance, governmentally provided or subsidized transportation, entertainment, and recreation); 3) household assets (consumer durables) accumulated over a lifetime; and 4) private transfers from various sources. In combination, these transfers and sources of implicit income may easily exceed reported money income. Property tax payments as a percentage of total economic income will, therefore, be substantially less than that reported in some studies which use only money income.

IV

Conclusions

THE FOUNDATION for property tax circuit-breakers is weak and suspect. The economic consequences of these reform programs are significantly different than their originally intended effects:

1. If the property tax is, in fact, progressive, then there are persuasive reasons to conclude that circuit-breakers, as currently implemented, redistribute income "perversely"—(*i.e.*, from low to high-wealth households.) If the property tax is progressive, then the benefits accrue largely to higher income families and hence increase income inequality.

2. Regardless of the regressivity issue, any short-run net redistribution to the poor or elderly is likely to be short-lived. Even if property tax relief benefits the current generation of low income elderly, the long-run distri-

bution of income is unlikely to change since individuals, over their lifetimes, will merely shift the timing of their property tax payments. In other words, households will end up paying higher taxes earlier in life to offset the reduced tax payments later.

3. In the absence of infra-marginally relevant positive externalities, such housing subsidies for the elderly encourage their overconsumption of housing and a misallocation of resources in the housing market.

4. Circuit-breakers reduce the tax base of local governments, thus requiring higher tax rates on a smaller base. This thereby increases the dead weight (excess burden) inefficiencies caused by all forms of taxation.

Given these findings, the direct and indirect long-run costs of circuit-breakers to society appear to exceed any net benefits. Therefore, selective property tax relief as a matter of public policy should be abandoned, and current circuit-breaker programs should be repealed.

Notes

1. ACIR, *Fiscal Balance in the American Federal System*, Vol. 1 (Washington, D.C.: U.S. Government Printing Office, 1967).

2. ACIR, *Financing Schools and Property Tax Relief—A State Responsibility* (Washington, D.C.: U.S. Government Printing Office, 1973).

3. Henry George, *Progress and Poverty* (1879).

4. Phillip May and Makhlis Zaki, "The Michigan Circuit-Breaker and its Impact on the Incidence of the Property Tax," *American Journal of Economics and Sociology*, Vol. 39, No. 2 (April 1980), p. 169.

5. John H. Bowman, "Property Tax Circuit-Breakers Reconsidered: Continuing Issues Surrounding a Popular Program," *American Journal of Economics and Sociology*, Vol. 39, No. 4 (October 1980), p. 355.

6. For specific descriptions of the various state programs, see ACIR, *Property Tax Circuit-Breakers: Current Status and Policy Issues* (Washington, D.C.: U.S. Government Printing Office, 1975).

7. Helen F. Ladd, "The Role of the Property Tax: A Reassessment" in Richard A. Musgrave, ed., *Broad-Based Taxes: New Options and Sources*, A Supplementary Paper of the Committee for Economic Development (Baltimore: Johns Hopkins Univ. Press, 1973), p. 65.

8. "Property Tax Circuit-Breakers Reconsidered," *op. cit.*, p. 359.

9. Henry Thomassen, "Circuit-Breaking and Life-Cycle Lock-In," *National Tax Journal*, Vol. 31, No. 1, March 1978, pp. 59–65.

10. For explicit reference to circuit-breakers, see Thomas R. Ireland and William E. Mitchell, "A Public Choice Analysis of the Demand for Property Tax Circuit-Breaker Legislation," *Public Finance Quarterly*, Vol. 4, October 1976.

11. For a general discussion of rational, constitutional legislation, see Gordon Tullock, *The Logic of the Law* (New York: Basic Books, Inc., 1971), Chapter 2, pp. 10–34, and James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor, Michigan: University of Michigan Press, 1962). Also, see James M. Buchanan, *Constitutional Restrictions on the Power of*

Government, 1981 Frank M. Engle Lecture of The American College, Bryn Mawr, Pa. Also, see John Rawls, *A Theory of Justice* (Cambridge, Mass.: Harvard University Press, 1972).

12. Edgar K. Browning, "Why the Social Insurance Budget is Too Large in a Democracy," *Economic Inquiry,* Vol. 13, No. 3, September 1975, pp. 373–388.

13. *Financing Schools and Property Tax Relief,* p. 13.

14. *Ibid.,* p. 6.

15. Walter J. Blum and Harry Kalven, *The Uneasy Case for Progressive Taxation* (Chicago: Univ. of Chicago Press, 1953).

16. James M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review,* Vol. 40, September 1950, pp. 583–599 and Richard A. and Peggy B. Musgrave, *Public Finance in Theory and Practice* (New York: McGraw-Hill Book Co., 1980), Chapter 12, pp. 256–279.

17. Dick Netzer, *Impact of the Property Tax,* National Commission on Urban Problems (Washington, D.C.: U.S. Government Printing Office, 1968); ACIR, *Financing Schools and Property Tax Relief,* and Musgrave and Musgrave, *op. cit.* Also, see John F. Due and Ann F. Friedlander, *Government Finance: Economics of the Public Sector* (Homewood, Ill.: Richard D. Irwin, Inc., 1981), pp. 464–65.

18. See, for example, Edgar K. Browning and Jacquelene M. Browning, *Public Finance and the Price System* (New York: Macmillan, 1979), pp. 385–91.

19. Peter Mieszkowski, "The Property Tax; An Excise Tax or a Profits Tax?", *Journal of Public Economics,* Vol. 1, April 1972, pp. 73–96.

20. *Public Finance and the Price System,* p. 390.

21. *Ibid.*

22. Edgar K. Browning, "The Burden of Taxation," *Journal of Political Economy,* Vol. 86, August 1978, pp. 649–71.

23. Edgar K. Browning, "The Trend Toward Equality in the Distribution of Net Income," *Southern Economic Journal,* July 1976, pp. 912–23. Also see Henry Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938).

Plant Closing Costs, in Human Terms

AMERICAN BUSINESSES are again leaving northern industrial cities for the greener pastures of the South and Southwest. With these results, according to one author: "The year Federal Mogul shut down the Shoemaker plant it reported record sales and more than $14 million in profits. The company's employees, however, didn't fare so well. In the aftermath of the closing, at least seven of Jim Farley's fellow workers took their lives."

The serious economic and ethical issues raised by corporate abandonments and shutdowns are addressed in *Community and Capital in Conflict: Plant Closings and Job Loss,* edited by J. C. Raines, L. E. Berson and David McI. Graci (Philadelphia: Temple Univ. Press, 1982, $19.50). The work emerged from a conference of church people, neighborhood activists and academic specialists. [From the publisher.]

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