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Does the Property Tax Have a Future?

DICK NETZER

In 1956 one of the most perceptive analysts of state-local finance, George W. Mitchell, forecast to the annual conference of the National Tax Association that, in twenty years, "the property tax . . . will have become an all-but-forgotten relic of an earlier fiscal age."¹ Mitchell had been heavily involved with the property tax as a scholar and as a state tax official during the 1930s and 1940s, and his comment had a solid basis in what was then recent history. The property tax, which had provided some 80 percent of all state-local tax revenue until the early 1920s, was providing only 45 percent of that total in the mid-1950s. At that rate of relative decline (1.25 percentage points a year), the property tax would be expected to account for only 15 percent of state-local tax revenue in 1980, perhaps not an all-but-forgotten relic but surely no longer the mainstay of local-government finance in the United States.

A decade later, in 1966, the present writer—observing from the vantage point of a decade of stability in the relative role of the property tax, at the 45–46 percent level—reflected on a "new complacency" about the role of the tax.² But even as that study was being published, the decline in the role of the property tax had resumed. Just before Proposition 13 was passed in June 1978, the property-tax share had declined to 34 percent; in the twelve months ending June 30, 1981, it was 30 percent. Looking ahead to the turn of the century one might ask: Was Mitchell right, but one generation premature? Or is the role of the tax likely to stabilize over the next generation, playing a crucial, if no longer dominant, part in state-local finance, especially local-government finance?

The level of the property tax in the future as well as its form (in terms of

¹ George W. Mitchell, "Is This Where We Came In?" *Proceedings of the Forty-Ninth Annual Conference*, National Tax Association (1956), p. 494.

² Dick Netzer, *Economics of the Property Tax* (Washington, D.C.: The Brookings Institution, 1966), pp. 3–8.

coverage of the various types of property and the extent of differentiation in the treatment of classes of property and property owners) will of course be the result of developments in each of the fifty-one state "systems" that compose the property-tax system in the United States. It can be predicted with confidence that outcomes will differ among the states, as they always have in the American federal system. (This result is in contrast to most other nominally federal countries that somehow end up with nationally uniform results.) However, there are economic variables that will affect policy decisions all across the country. Moreover, the political consensus on what is good and bad public-finance policy tends to be contagious. Decisions about school finance, circuit-breakers, Proposition 13, and the like in one state tend to be imitated in some, if not all, other states.

The balance of this essay explores the two main influences on the future of the property tax. The first is how the tax base is likely to change in the light of what seem to be plausible long-term economic trends, that is, in greatly oversimplified language, the likely income-elasticity of the base. The second is the likely political consensus on the worthiness of the property tax and its major features. The latter discussion involves answering several questions. What are the convictions about state-local finances in general and the property tax in particular that resulted in the last fifteen years of relative decline in the property tax? Will those convictions remain relevant and operational in the circumstances of the next twenty years? How are attitudes toward the tax likely to change, given that — as John Maynard Keynes pointed out — politicians are often the unwitting prisoners of defunct academic scribblers?

The Property-Tax Base

The ideal situation for a local government that is heavily dependent on the property tax might be described in the following terms. There is no inflation to speak of. Property values nonetheless increase more rapidly than the income of the resident population because of new construction and other physical improvements. Therefore, the local government can raise a constant amount of property-tax revenue with little change in the tax bills of most individual taxpayers, whose taxes are presumably a declining percentage of their incomes. This situation is ideal in that it affords a minimum of political contention.

In the real world, however, there is inflation, and the relationship between the income of property-tax payers and their tax bills is seldom so satisfactory. Some confront tax bills that rise more rapidly than income. Most property owners are in effect taxed on unrealized capital gains, much or all of which is nominal rather than real. There will be contention. But the contention, and public perceptions about the fairness of the property tax, will surely be less if the tax base is expanding more rapidly than income, in real terms, than if the tax base is expanding more slowly. What are the prospects?

Economic theory suggests that, in the contemporary United States economy,

the property-tax base should increase over time more slowly than national income and product and that this should have been especially so in the circumstances of the 1970s. There are at least five reasons for this conclusion. First, the normal expectation is that business investment in structures and equipment will increase in productivity over time, that is, that the capital stock will yield increasing output per dollar of investment, if only because replacement investment is usually triggered not by the physical deterioration of the old stock but by opportunities to replace the existing structures and equipment with more profitable ones. Second, the economy has shifted from a manufacturing emphasis to a service emphasis. Manufacturing tends to be structures- and equipment-intensive. So are some service activities, like telecommunications, but many service activities are not. Moreover, a significant fraction of service activities are performed by tax-exempt entities, such as health services and education. Third, a slow growth in population should mean less intense housing demand, with an obvious impact on the value of the stock of residential capital. Fourth, slow growth in population and economic activity combined should imply relatively slow growth in land values. Fifth, high real-interest rates – which emerged for the first time in many years in the late 1970s and which are expected to be the normal situation for the foreseeable future – tend to depress the value of all capital, in both real and nominal terms.

The most pessimistic hypothesis about the condition of the United States economy over the next generation is that it will be more like the 1970s than the 1960s or 1950s. Some recently published data, developed by Richard and Nancy D. Ruggles largely on the basis of the U.S. Commerce Department (Bureau of Economic Analysis) estimates of the nation's capital stock, indicate how that capital stock changed relative to the gross national product (GNP) during the 1970s. These data are summarized in table 1; the starting year is 1969, the terminal year of the long boom of the 1960s.

With a single exception, the value of every category of asset owned by the enterprise and household sectors rose more rapidly in this period than did the GNP, whether the measure is current dollars or constant 1972 dollars. That single exception is household inventories of nondurable goods, like food, clothing, and fuel, which have never been reached by the property tax even when coverage was supposedly completely general. The indicated elasticity of privately owned tangible assets with respect to GNP was in the +1.2 range for the more important categories (owner-occupied housing, other real property, and enterprise-owned personal property) in current-dollar terms, and +1.5 or more in constant-dollar terms. Even the weakest category, the value of tenant-occupied housing, increased more rapidly than GNP.

The Ruggles data are far from being identical with the property-tax base. For one thing, they include in the enterprise sector property owned by government enterprises and nonprofit organizations that is usually exempt from property taxation. However, there is some evidence that such property increased in value less rapidly during this period than did ordinary privately owned property.

TABLE 1
*Average Annual Percent Change in Value of Land and Reproducible Assets,
 1969–80*

	Current Dollars	1972 Dollars
All land and reproducible assets	11.56	4.54
Owned by government	10.68	3.72
Owned by enterprises and households ¹	11.76	4.73
Land	11.84	4.80
Structures	12.34	5.27
Durables and inventories	11.00	4.02
Owner-occupied housing ²	12.94	5.84
Land	13.68	6.53
Structures	12.73	5.64
Other real property ³	11.66	4.65
Land	11.16	4.17
Residential structures	10.87	3.90
Nonresidential structures	12.39	5.32
Enterprise-owned personal property ²	11.80	4.76
Durables	12.01	5.00
Inventories	11.50	4.48
Household-owned personal property	9.84	2.93
Durables	10.25	3.32
Inventories	8.14	1.33
Exhibit: GNP	9.78	3.14

Source: Data in Richard Ruggles and Nancy D. Ruggles, "Integrated Economic Accounts for the United States, 1947–80," *Survey of Current Business*, May 1982.

¹ Enterprise sector includes government enterprises and nonprofit organizations.

² In these data, this is the only real property owned by the household sector.

³ All owned by enterprise sector; see note 1 above.

Bureau of Economic Analysis data show that this was true in the 1969–79 period for nonresidential structures, residential structures, and nonresidential durable equipment.³ Thus, unless the value of land owned by government enterprises and nonprofit organizations increased considerably more rapidly than the value of land owned by ordinary businesses and individuals—which seems implausible—the data in table 1 marginally understate the elasticity of the value of the types of property ordinarily subject to property taxation with respect to GNP.

However, because a class of property is usually taxable does not mean that it is fully and consistently reached by the property tax. It could be that the narrowing of legal coverage, changes in the statutory basis for valuation, and the spread of all sorts of partial exemptions and other tax-relief devices have more than offset the underlying economic trends. The purist will observe that the economic capacity to pay property taxes, in the form of income to be tapped

³ U.S., Department of Commerce, Bureau of Economic Analysis, *Fixed Reproducible Tangible Wealth in the United States, 1925–79* (Washington, D.C., 1982), tables A-9, A-12, A-15, C-2, and C-4.

and wealth that can be liquidated, is not reduced by a legislative decision to narrow the statutory tax base. (Indeed, one can observe that the underlying economic trends with regard to the relation between income and tangible assets are not material, because effective tax rates can be and are changed to reflect public spending decisions.)

The policymaker, however, is likely to consider that observation beside the point. For one thing, some decisions to narrow the property-tax base are taken because of actual difficulties, new or long-standing, in collecting taxes on classes of property that are fully taxable. That is one of the explanations for removing some types of personal property from the tax base, a movement that is decades old but has gained popularity in recent years. It is difficult to locate and value many types of personal property, and states with shaky economies may consider the exemption of business personalty an essential economic-development measure: the investment may not be there to tax if the tax is imposed. More generally, political decisions to grant tax relief to new business investment or homeowners or the elderly are usually seen as reductions in the economic base of the property tax, offset by increasing effective property-tax rates on the remaining tax base only at considerable peril. Usually, property-tax-base narrowing is expected either to be financed from other revenue sources or, painlessly, by expanded economic activity, not by a redistribution of the burden.

A comparison of the statutory property-tax base with estimates of national wealth over time is anything but straightforward. First, there are serious disagreements among the alternative sets of national-wealth estimates, especially but not exclusively concerning the value of land. It is by no means clear which estimates are the most appropriate. Second, as noted above, it is difficult to separate from the wealth estimates some of the categories of property that are generally not subject to the property tax. Third, there are major differences among the states in the statutory treatment of personal property. Fourth, there are important categories of taxable property assessed, usually by state government agencies, without regard to the distinction between real and personal property.

One set of estimates of the behavior of the tax base itself in the 1960s and 1970s was incorporated in some work done by David J. Levin of the U.S. Department of Commerce.⁴ Levin analyzed the year-by-year sources of increase (inflation, real growth in the base, and legislative actions) in the major state-local taxes, including "indirect business property tax accruals," that is property-tax collections exclusive of property taxes on household-owned personal property, which are estimated to account for less than 2 percent of total property-tax collections. He utilized census data on assessed and market value of taxable

⁴ David J. Levin, "Sources of Growth in Selected State and Local Government Tax Receipts," *Survey of Current Business*, February 1982, pp. 15-17. Further elaboration of the methods and data was provided in a letter from Levin to the present author dated May 5, 1982.

property as benchmarks and national wealth estimates for interpolation. For the 1969–80 period, his data suggest the following average annual rates of increase:

Market value of taxable property in current dollars	11.2 percent
Assessed values	10.2 percent

These estimates indicate that the market value of property actually on the tax rolls increased somewhat more slowly than national wealth in forms that are ordinarily taxable (see table 1). The margin was roughly one percentage point. Assessed values lagged by another percentage point. But either measure of the tax base showed a rate of increase in excess of the GNP current-dollar growth rate of 9.8 percent.

Another rough comparison can be made, by combining the Ruggles data, other Bureau of Economic Analysis data, and data from the quinquennial *Census of Governments* on the assessed value of property subject to tax and the estimated market value of locally assessed real property, with the aid of numerous estimates by the investigator at strategic points. It would be inappropriate to lead the reader through these technical thickets. Therefore, only the conclusions are reported here, for changes over the decade from 1966 to 1976, the latter year being the most recent one for *Census of Governments* data. For this period, the national-wealth estimates of the value of land and structures owned by households and businesses show that value is increasing about one-third more rapidly than GNP, whether the comparison is in current or constant dollars (the measurement here is the form of an elasticity calculation, yielding an elasticity of about +1.34).

The estimated market value of locally assessed real property increased about 11 percent more rapidly than current-dollar GNP, which suggests that the property-tax base did not capture all of the increase in the real-property wealth of taxable entities. Even so, the increase was in excess of GNP. The assessed value of this property increased about as rapidly as its estimated market value, but there were divergent trends behind these aggregates. The ratio of assessed to market value of single-family houses declined, while the ratio for other locally assessed real property increased. However, for both categories, the rate of increase in assessed values, the statutory property-tax base, was well in excess of that of current-dollar GNP.

The property-tax base in the United States covers more than land and structures. In most states, the base includes some forms of personal (as distinguished from real) property—business and farm equipment and inventories, motor vehicles (in about half of the states), and, in a few cases, some types of consumer-owned durable goods. As table 1 shows, the growth in the value of the stock of these assets, especially business-owned personal property, has been considerable. As of 1979–80, an estimated 14 percent of all property-tax revenue was derived from personal property.

However, the disparity between the amount of national wealth in these forms

and the extent to which it is included in the property-tax base is large and increasing. As of 1979, assessed values on assessment rolls equaled 30 percent of the estimated value of privately owned real property but only about 10 percent of the estimated value of privately owned personal property of the types subject to property taxation in any state. Moreover, this fraction has been declining over time, mostly – but not entirely – because the states are increasingly removing some types of personal property from the tax base by statutory or constitutional provisions. In 1956, about 64 percent of the national wealth in these forms was located in states subjecting them to tax. By 1979, that percentage had declined to 55. Between 1956 and 1979, although the stock of these assets increased in value more than the rise in GNP, the assessed value of personal property subject to tax increased less rapidly than GNP, and property-tax revenue derived from personal property increased much less rapidly (the elasticity estimate is $+0.76$). If anything, the trend toward removing personal property from the tax base has accelerated during the past five years.

Thus, although the long-term elasticity of the property-tax base with respect to national income and product should be relatively low, on the basis of economic theory, it was not low in the 1970s. However, the crude estimates presented above indicate that the overall result was the consequence of a low elasticity for nonreal property reached by the tax, a moderate figure for nonresidential real property, and a high figure for owner-occupied residential property.

These divergent trends could imply a significantly lower overall property-tax base elasticity in the future, in the light of recent changes in the federal tax structure and plausible expectations with regard to the economy. The most likely economic scenario has relatively high rates of investment in business equipment and inventories, increasing portions of which are not included in the property-tax base; moderately slower rates of investment in business real property, not all captured in the property-tax base (to a minor extent because of local economic-development tax incentives but also because mineral and energy-producing real property tends to be specially, and favorably, treated in property taxation); and considerably slower rates of investment in owner-occupied housing (because of the demographics, high real interest rates, and relatively diminished income-tax advantages), which the property-tax base does capture, although housing-tax preferences prevent much of this investment from being fully taxed once on the assessment rolls. If this scenario is borne out, the high tax-base elasticity that has characterized the decades since World War II may be a thing of the past.

So far, this discussion has been in terms of national aggregates. The property tax is not a national tax, however, and there are sharply differing trends in regional economies. How has the property-tax base reflected these divergences? The answer is: with a vengeance. One type of divergence is shown in table 2, which refers to percentage changes in the gross assessed value of property subject to local general property taxation between 1966 and 1979. (The years were

TABLE 2

Geographic Disparities in Growth of the Property-Tax Base: Percent Change in Gross Assessed Value of Property Subject to Local Government General Property Taxation, 1966–79

Area	Assessed values adjusted for changes in assessment ratios ²			
	Reported assessed values ¹		Assessed values adjusted for changes in assessment ratios ²	
	In current dollars	In constant dollars ³	In current dollars	In constant dollars ³
13 declining cities in large metropolitan areas in the Northwest and Midwest ⁴	+ 39	– 49	+ 110	– 23
Central county (or counties) of 18 large growing metropolitan areas in the West and South ⁵	+ 328	+ 58	+ 324	+ 57
Rest of U.S.	+ 267	+ 36	+ 287	+ 43
All U.S. areas	+ 236	+ 24	+ 261	+ 34

¹ From U.S. Bureau of the Census, *1967 Census of Governments*, vol. 2, *Taxable Property Values* (1968) and *Property Values Subject to Local General Property Taxation in the United States: 1979* (Series GSS, No. 98, 1980).

² Estimated change in assessed values if the 1966 ratios of assessed values to sales prices for locally assessed real property had not changed over the period and assuming that the changes in assessment ratios for locally assessed real property were reflected in the ratios for other types of property. Estimated by the author on the basis of assessment-ratio data in the 1967 and 1977 *Census of Governments*, supplemented by more recent data for a number of major jurisdictions.

³ Current-dollar figure deflated by implicit price deflator for structures and private purchases of producer durables.

⁴ Includes thirteen of the nineteen standard metropolitan statistical areas (SMSAs) in the Northeast and Midwest with a 1980 population over 1 million. Five of the excluded SMSAs have been growth areas (Columbus, Indianapolis, Kansas City, Minneapolis, and Washington); the sixth is Nassau-Suffolk, a predominantly suburban area without a central city. In three cases, the assessed values are for the central county, not the central city alone.

⁵ Includes eighteen of the nineteen SMSAs in the South and West with a 1980 population of over 1 million. The exclusion is New Orleans, not a rapid-growth area. The assessed values are for the entire central county, or counties, where there are two central cities.

chosen because of the availability of Census Bureau assessed-value data for those years.) The first line shows assessed-value data for thirteen large central cities in the Northeast and Midwest, all with declining populations and located in metropolitan areas that are, at best, slowly growing ones. The second line provides similar data for the central portions (counties) of eighteen rapidly growing metropolitan areas in the West and South.

Reported assessed values (column 1) in those growth areas in the Sun Belt more than quadrupled in the thirteen-year period but increased by only 39 percent in the declining cities of the North. In the rest of the country, the increase was far more rapid than in these declining cities but less rapid than in the Sun Belt. To some extent, these disparities reflect not changes in the underlying tax base but instead divergent assessment practices, ranging from serious efforts to reflect increasing market values on the assessment rolls to virtually frozen

assessments for many years to, in a few places, wholesale revaluation to higher percentages of market value.

Column 3 of table 2 presents rough estimates of how assessed values would have changed, for the groups of places, had the 1966 ratios of assessed to market values in each place remained constant over the entire period. Paradoxically, in the declining cities, where market values were not rising steeply, assessments tended to lag behind even the moderate rises in market value, with an average decline of one-third in assessment ratios for the thirteen cities (though two of them, Detroit and Milwaukee, had higher assessment ratios at the end of the period). Meanwhile, in most of the growing areas where market values were climbing rapidly indeed, there were serious efforts to maintain assessment ratios, notably in Florida and California. Moreover, in Seattle and Portland, there were wholesale upward revaluations to much higher assessment ratios; this also happened to a lesser extent in San Francisco and Atlanta. Lagging assessments in Texas and in Phoenix did not offset these efforts, so that the average assessment ratio for the eighteen growing areas increased slightly. In the rest of the country there was, on average, a small decline in assessment ratios.

Consequently, the estimate is that assessed values so adjusted increased by about 110 percent in the declining cities, while they more than quadrupled in the growing areas. This translates into a decline in constant-dollar terms of nearly one-fourth in the declining cities and an increase, in these terms, of 57 percent in the growth areas (and 43 percent in the rest of the country). Moreover, the declining cities fared relatively worse in respect to property values than they did in economic activity generally, as measured by personal income; personal income rose about twice as rapidly in the growing areas as in the declining areas, not three or more times as rapidly. The implications are dismal for the declining cities. To maintain property-tax revenue at a constant level in real terms, the declining cities would have had to post large increases in effective property-tax rates and absorb larger fractions of personal incomes in property-tax payments, conceivably further undermining their fragile economies. Meanwhile, in the growing areas, a constant level of property-tax revenue in real terms (even in real terms per capita) could have been maintained with declining tax rates.

In any event, the shrinking role of the property tax in state-local finance during the period meant that property-tax revenue was not maintained in real terms, in either the declining cities or the growing areas; as table 3 shows, property-tax revenue roughly doubled in both groups. Consequently, effective property-tax rates (property-tax revenue as a percentage of assessed values adjusted for assessment-ratio changes) were unchanged, on average, in the declining cities, and declined by about one-half in the growing areas, partly but by no means entirely because of the massive tax reduction following the adoption of Proposition 13 in California in 1978. Nominal property-tax rates (revenue as a percentage of actual assessed value) rose sharply in the declining cities. Property-tax revenue as a percentage of personal income declined slightly (the rise in personal income is somewhat overstated in table 3, as footnote 4 in the table indicates) in the declining cities and sharply in the growing areas.

TABLE 3

Geographic Disparities in Growth of the Property-Tax Base, Property-Tax Revenue, and Personal Income, 1966-79 (Percent Change over Period)

	13 declining cities ¹	18 growing areas ¹
Reported assessed values ²	+ 39	+ 328
Assessed values adjusted for changes in assessment ratios ²	+ 110	+ 324
Property-tax revenue, 1966-67 to 1979-80 ³	+ 112	+ 108
Personal income ⁴	+ 139	+ 269
Change in property-tax revenue as percent of: ⁵		
Assessed values	+ 52	- 51
Adjusted assessed values	+ 1	- 51
Personal income	- 12	-44

¹ Areas are those identified in table 2.

² From table 2.

³ 1966-67 data from U.S. Census Bureau, 1967 *Census of Governments*, various volumes; 1979-80 data from U.S. Census Bureau, *Local Government Finances in Selected Metropolitan Areas and Large Counties: 1979-80* (Series GF-80, No. 6, 1981).

⁴ From *Survey of Current Business*, April 1980 and April 1982, and unpublished Bureau of Economic Analysis tables. Personal-income data are on a county basis, and a number of the declining cities are portions of larger counties. The personal-income series is not entirely comparable to the revenue and property-value series; the rise in personal income is somewhat overstated relative to the increases in the other series.

⁵ Calculated from unrounded data.

If these trends persist, tax-base inadequacy will continue to be a serious problem in the large central cities of the Frost Belt, leading to further declines in the role of the property tax there. In the rest of the country, the tax base will grow in real terms but perhaps not as rapidly in relation to income as in recent decades. However, there has been some reluctance to tap that growing tax base fully, especially in the areas undergoing the most rapid economic growth; some of the reasons for this are explored in the following section. If voters and their representatives in the growing parts of the country are unwilling to countenance property-tax bills that are a constant percentage of property values or personal income, then there will not be much of a property tax in our future.

Attitudes toward the Property Tax

It is doubtful whether the property tax was ever considered a good tax by Americans: at best there was a grudging acceptance, at worst "taxpayer revolts" of the Proposition 13 variety. For decades, scholars also held the tax in contempt, in part because of the dreadful quality of tax administration, in part because of what were seen to be inherent defects. The massive reduction in the role of the property tax in the quarter-century ending in the early 1950s reflected both the popular hostility and the academic scribbling that rationalized reforms in the property tax itself and increased emphasis on other sources of finance for the state-local sector.

Since then, there have been some major fluctuations in the scholarly appraisal of the institution: a predominant view, in the 1950s and early 1960s, that the tax could be reformed and “rehabilitated” to be a decent one; a new wave of criticism, in the late 1960s, that the tax was indecently regressive in incidence, especially for financing schools (to which the present author was a not entirely wholehearted contributor); the revisionist theorizing of the 1970s, to the effect that the tax was really highly progressive in incidence and therefore a good tax at least in theory, if not as actually administered; and the present synthesis, which holds that the tax in all its variety across the nation combines elements of decided and unfortunate regressivity, elements of equally unfortunate effects on the location of economic activity, a significant user-charge aspect that is meritorious and neutral with respect to both income distribution and the location of economic activity, and even some progressive incidence elements.

So the present academic appraisal of the tax is comparatively benign, if not exactly favorable. Voter hostility, however, appears to be as marked as ever. There are apparently two reasons for this conflict in attitudes. First, scholars tend to view increases in wealth, including wealth in the form of housing, as proper indicators of taxable capacity, whether or not those increases in wealth are realized by a sale of the assets in question. Voters tend to view taxes on unrealized capital gains as indecent, and most are hostile to taxes on realized capital gains on housing. Second, scholars view taxes, especially residential property taxes, as prices for public services that, like other prices, properly induce consumers to make changes over time in their consumption patterns. Voters increasingly tend to believe that increases in housing costs, especially the element of costs called the property tax, are illegitimate and should not be permitted to affect housing consumption decisions. The two reasons are related: homeowners realize capital gains only when they move; those who are unwilling to make changes in their housing status will not realize such gains.

How important are unrealized capital gains on owner-occupied housing? Obviously, the answer depends on the rate of turnover. The high rate of mobility of Americans suggests that turnover rates must be high. Indeed, among housing-market analysts, a rule of thumb is that the bulk of long-term adjustments to housing-market stimuli are effected within seven years or less. However, the data on sales of existing single-family housing show much lower rates, ranging in the 1970–80 period from 3.6 to 7.5 percent annually. Thus, if all property is annually revalued at current market values (as scholars and good-government advocates urge and as many jurisdictions do), the assessment rolls will reflect capital appreciation on many houses that have not been sold for years.

The data developed by the Ruggleses and the Bureau of Economic Analysis provide the basis for a crude estimate of the relative importance of unrealized capital gains in the recent past, specifically for nonfarm owner-occupied housing in the 1969–79 period. The estimation process entails assuming that the assessment rolls change each year only for these reasons:

1. When existing houses are sold, they are reassessed at the sales price.

2. Newly built houses are added to the rolls, at selling price or construction costs.

3. Houses that are removed from the stock (because of fire, abandonment, or conversion to other uses) are removed from the rolls, at their current market values.

Now, for these purposes, assume unrealistically that at year-end 1969 all owner-occupied nonfarm housing was on the assessment rolls at current-market value, roughly \$650 billion according to the national wealth estimates. By year-end 1979, the current-market value of this housing was roughly \$2.2 trillion. If the assessments at year-end 1969 were \$650 billion and the above rules were followed, the assessed value of this housing would have been \$1.6 trillion at year-end 1979. That is, of the total increase in the market value of \$1.55 trillion, about \$600 billion represented increases in the value of existing, unsold properties. The remaining \$950 billion reflected increases in the value of existing properties that changed hands and the net investment in new housing. More than one-fourth of the total market value of this housing stock reflected unrealized capital gains.

If voters view property taxation of that portion of the tax base as improper, then of course the tax will be considered illegitimate in jurisdictions that follow the expert advice and keep assessments current with market values. It will be considered especially illegitimate in areas where property values are rising with extraordinary rapidity and therefore the unrealized capital gains are especially large. As noted earlier, assessments have tended to track the market in the growth areas, such as California before Proposition 13. Generally speaking, the only really bad laggards have been the older central cities; in most such cities, unrealized capital gains on homeowner properties have not been reflected on the assessment rolls, except to a very limited extent. But elsewhere, the sense of injustice can be expected to be acute, all the more so because homeowners with only modest unrealized gains are unlikely publicly to applaud the assessor.

Obviously, the future extent of unrealized capital gains will depend heavily on the rate of inflation. Even with low inflation, there would be unrealized gains, the taxation of which would be unpopular. The not very startling forecast here is that state government action to shelter homeowners from property taxes based on unrealized gains will be very widespread over the next generation. More often than not, those actions will be in forms that are not conditioned by the income of the homeowner. Thus, substantial portions of the potential tax base will be effectively removed from property taxation. If all unrealized gains on homeowner properties were excluded from property taxation and property taxes on other taxpayers did not increase to offset this exclusion, aggregate property-tax revenue might be as much as one-tenth less than it is now. That is, other things being equal, the property tax would account for about 27 percent of state-local tax revenue, rather than the 30 percent it now provides.

The political appeal of the exclusion of unrealized capital gains from property taxation seems overwhelming. Thus, virtually every state now requires assessment of farm property on the basis of current-use value. Proposition 13 (as well

as similar provisions in some other states) severely limits the increases in assessments of unsold properties. Perhaps the most extreme case is found in New York State's December 1981 property-tax "reform" law (which may well prove to be unconstitutional). That law ostensibly provides for a classified-property system, with uniformity in assessments within classes. However, the assessed value of any individual one-to-three-family property that remains unsold may not be increased by more than 20 percent in a five-year period in the jurisdictions with large intraclass disparities in assessment ratios, notably New York City. There are large numbers of such properties in "gentrified" areas with assessment ratios of one-third or less of the already low average for the entire class. If there were no change whatever in market values, or if the market value of all properties in the class increased uniformly, it would take thirty years to reach uniformity under this restriction. If market values in the gentrified areas increase by 2 percent a year more rapidly than for the class as a whole, it would take sixty-four years to achieve uniformity. The rather obvious objective of the restriction is to preclude even the attempt to reach unrealized gains.

The popular notion that property taxes should not affect the housing decisions of consumers (or farmers' investment decisions) supports further limitations on the potential of the property tax, going beyond the exclusion of unrealized capital gains from the tax base. If homeowners' and farmers' decisions are to be insulated from the property tax, then actual cash outlays for property taxes should reflect the changing economic circumstances of the individual taxpayer. One such change already is widely reflected: the reduction in current income that usually accompanies old age, recognized by circuit-breakers and other property-tax preferences for senior citizens. With an aging population, an increasing share of the housing stock will be so sheltered from full property taxation. If relatively severe economic fluctuations continue, it is plausible to expect the passage of state laws, in the more vulnerable states, offering temporary property-tax abatements triggered by unemployment or a sharp decline in the earned income of the taxpayer. High real-interest rates for mortgages would increase the pressure for such property-tax relief. Moreover, it seems most unlikely that jurisdictions offering generous property-tax relief to business taxpayers, in order to stimulate weak local economies, will be able to avoid some gestures toward individual homeowners confronting economic adversity.

On the other hand, two related factors that have contributed to the declining importance of the property tax in the past fifteen years may be of less importance over the next two decades. The first is the stigma of regressivity, and the second is school-finance reform leading to the substitution of state taxes for local property taxes. It is probably true that the property tax is seen today by most elected officials, editorial writers, and "informed laymen" to be an exceedingly regressive and therefore an unattractive instrument for financing government. That was not the case twenty years ago. The only plausible explanation for the change in attitudes is that today's officials and opinion-makers have been swayed by what they were told by their academic mentors in college

and law school and at public hearings of legislative bodies. If this explanation is valid, then the next generation of officials and opinion-makers are likely to be less hostile to the tax, for academics are now telling them either that the tax is not all bad in incidence terms or that it is a perfectly splendid engine of progressive income-redistribution.

Historically, at least half of all property tax revenue has been utilized to finance schools. Between the mid-1960s and 1979, there was a major shift in the nature of school finance; the relative roles of the state and local levels of government reversed. In the mid-1960s, local governments provided about one-half of school support and the states about one-third. By 1979, the local share was about one-third and the states' share one-half. A very large fraction of the local-government share has been derived from property taxation. The implication is that, without this shift, the property tax would have accounted for about 35 percent of state-local tax revenue in 1979-80, not 30 percent.

The shift stemmed both from the general hostility to the property tax, including that reflected in limitation provisions (since state aid for schools is an old tradition, a fairly obvious way to reduce property taxes is to increase state school aid), and from deliberate efforts to provide more intrastate equalization in school finance. In some important states, like California and New Jersey, the equalization efforts were dictated by state court decisions ruling the existing systems in violation of the state constitutions. More recently, the judicial tide has turned; in the past five years, most state supreme courts ruling on the issue have upheld the constitutionality of the existing systems.

Thus, judicial pressure for reform may be absent. Meanwhile, state governments may be assuming fiscal responsibilities for nonschool activities that in palmier days were being increasingly shared by federal aid, so the state governments are unlikely to be well situated to finance more school costs, especially the states that are not well endowed with energy resources. The fact is that, in the energy-rich states, the state governments even now provide the bulk of school financing. Heavy property-tax support for the schools is now mostly confined to some of the energy-poor northeastern and midwestern states. On balance, therefore, the best forecast seems to be that the role of the property tax in school finance will decline slowly rather than rapidly in the foreseeable future.

It is much more difficult to make any kind of forecast about the relative role of the property tax in financing the remainder of its traditional "turf," local-government property-related services, public-safety expenditures, and general administrative costs. On the one hand, more than a generation of preaching by academics to the effect that user charges are the most appropriate source of finance for many such activities and that some of these activities involve geographic spillovers calling for finance over wider areas (often meaning non-property tax sources) might be expected eventually to affect legislative decisions. On the other hand, there is scant evidence of such effects with respect to user charges to date, and there may very well be less, not more, federal-

government financing of ordinary local-government activities in the years ahead; most – but not all – academics would endorse the latter.

Conclusion

A further decline in the role of the property tax over the next twenty years seems almost inevitable. First, there is the prospect that the income-elasticity of the economic tax base may be smaller than it has been in the recent past. Second, the legal tax base will surely continue to narrow, via a variety of tax-preference devices and the pressure to exclude unrealized capital gains from taxation. Third, the very large regional disparities will work in this direction; in the regions where the economic tax base is growing rapidly, there will be little need to tap the base more heavily, while in the weak regions the base will not even exist.

However, large-scale shifts away from the property tax based on explicit decisions to change the distribution of responsibility for financing major services, notably schools, seem less likely. Much of that shifting has already occurred, and the times do not seem propitious for new rounds of shifting – unless there is an improbable popular conversion to the notion that user charges are a good thing.

On balance, the property tax does have a future, providing perhaps 20 percent of state-local tax revenue twenty years from now, compared to the present 30 percent. The tax will remain important in state-local finance. More likely than not, however, it will be a tax that academic evaluators will like even less than they do the present one, with an even greater lack of uniformity among regions and jurisdictions and among types of privately owned wealth within jurisdictions.