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Property Taxation: Classifying Types of Property To Differentiate Burdens

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Property tax relief for homeowners has understandable appeal. With all taxes going up, the one "close to home"—on the home—offers a challenge to use voting power to slow the rise. One way is by "classifying" property, the graded tax, the split assessment roll; terms vary. The attractions of measures that discriminate in favor of homeowners are obvious when held out to voters.

One possible source of tax relief is to slow the rise in local government spending. Such is not the subject of this paper except to note that conditions differ and call for intelligent judgment based upon the realities of each community and of each of its public services.

Another possibility is to try to shift some of the cost of local government to "the other fellow." Perhaps we can put more on state and Federal taxpayers, forcing "them" to pay larger sales and income taxes. But "them" is likely to be "us," and routing funds through the state or national government presents problems rather than producing magic solutions. Is it possible, however, to make others bear more of the burden through manipulation of a local property tax? Through much of the country, property tax devices to do so now exist. Arguments in their favor usually come from a stated desire to help homeowners and farmers.

The aids to homeowners—and in some cases to renters—take various forms and do not all by any means fall within *classification* in the original sense. From one state to another, the *legal* provisions differ considerably—large or small homestead exemptions, assessment at different percentages of market worth, and circuit-breakers. Assessment inequality continues deliberately, extensively, and often substantially.

Examples of Legal Classification

One pattern stands out in formal provisions for discrimination. Relatively heavier tax burdens are imposed on business property. Most taxpayers, including probably many managers of business firms, will greet with favor the hope for relief from rising taxes on the home. But broader issues exist involving the general welfare, and our attention should not be limited to immediate and short-run effects.

In discussing classification here, I deliberately exclude one possible form which seems to me to have merit—reducing the relative weight on buildings and other man-made capital and relying more on land values. Nor does this discussion deal with those forms, usually called "circuit-breakers,"

This Issue in Brief

Property tax classification, usually aimed at lowering tax burdens on homeowners and farmers, can have long-run effects detrimental to the interests of the very groups it was designed to aid, states Professor Harriss.

In this article, the author explores some effects of proposals for classification which would shift tax burdens to business properties. "Every change which raises the tax on business property invariably weakens the economic base . . . and, in the long-run, the residents of areas seeking homeowner relief suffer," he concludes.

which attempt to deal with cases of need based on specific family circumstances and to make the tax conform more to our concepts of ability to pay and equity. This discussion will focus on the effort to shift taxes from owners and users of residential property to "business." A recent tabulation found that nine states, the District of Columbia, and Cook County, Illinois had formal provisions for such assessment discrimination.

For example, while Alabama assesses residential, agricultural, or forest parcels at 10 percent, it uses a 30 percent rate for utility property, while "all other" taxables are assessed at 20 percent. Louisiana provides a tax break for vacant land, residential and farm property, putting it on the assessment roll at 10 percent, while applying a 15 percent ratio to all other items. In Massachusetts, a constitutional amendment approved in 1978 permits four classification ratios: 40 percent for residential, 50 percent for commercial, 55 percent for industrial, and a special low rate of 25 percent for a category defined as "open space."

Minnesota has probably the most elaborate property tax classification system of any state, with numerous assessment ratios varying from 5 percent to 55 percent. For example, certain housing for the elderly or for low and moderate income families in communities of less than 10,000 is assessed at 5 percent of market value. Other homesteads are assessed at escalating ratios of from 5 percent to 40 percent applied to different amounts of market value. "Low grade" iron ore is put on the rolls at from 48.5 percent to 50 percent of market value, while unmined iron ore is assessed at 50 percent.

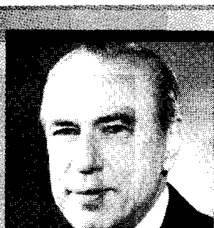
All Taxes Are "People Taxes"

All taxes must ultimately be paid by human beings. We shoulder the burdens in various forms—as taxes payable according to the income we receive, as higher prices for what we buy, as a reduction of the income that flows to us, and as a drop in the worth of our assets.

Does it make any difference whether we pay taxes directly on our income and purchases, seeing them clearly, or indirectly in various more hidden forms, among them discriminatory taxes on business enterprises? Yes, it does. Even though the dollar costs of government may seem the same, the imposition of taxes on business affects employment and the production of goods, services, and income.

Localities which burden business firms heavily will not only collect the dollars, but they will also experience the harmful results which flow from such taxes.

In any case "the people" must eventually pay all taxes. Is it not wise to do so in ways that do as little as possible to reduce the creation of income? The obvious answer is, "Yes." Yet this clear conclusion runs exactly counter to the trend to classify property taxes *against* business.



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Business as the Source of Jobs, Income, and Consumption Goods

Some Americans now show evidence of recognizing their deeper, broader interests, and public attitudes are beginning to reflect concern about competition for the economic base. Such views, contrasting with the "let's soak business" appeals, can help to prevent avoidable harm through adverse taxation.

Prosperous enterprise will benefit the people of a community. Although exceptions can be found—environmental damage and inappropriate types of activity—the predominant underlying reality is this: Over any substantial area—a state, a county, a city—business is overwhelmingly the most important *source* of income. Adverse property taxation through classification damages the productive base, and acceptance of such tax reflects misunderstanding of the role of business in the community.

Persons sincerely concerned about their own well-being, that of their fellow citizens, and the future of their children should take account of a basic economic reality: Real income originates, for the most part, in business. Productive enterprise is the source of goods and services and income. It makes no sense to hurt rather than try to help business. Awareness of the basic elements of economic life can help to forestall moves to classification of property tax, which, at first glance, may seem to be an "easy way out" of rising burdens on homeowners but which works to everyone's long-term disadvantage.

While the efforts of teachers, sanitation workers, engineers, and other employees of government—as well as the efforts of those who work for private nonprofit organizations—yield valuable results, most production and most income flow from what people accomplish through business firms. Corporations and unincorporated businesses are the major agencies for organizing labor, capital, and natural resources to produce—and to produce more efficiently rather than less efficiently.

Businesses are groups of people seeking to benefit themselves by serving others. These groups use capital which has been built up over time. Capital in the form of buildings, machinery, and inventory is crucial to human well-being. We see the importance of capital directly in housing. Capital is also needed for jobs and production. Capital per job (1980 dollars) of $40,000 to $50,000 is now common. A *good* job, one paying high wages (plus fringes), will generally require large amounts of capital. A 2-to-1 ratio of capital to labor—$2 of capital for each $1 per year of wages plus other employer costs—would not now be "high"—$40,000 for a job paying $16,000 plus $4,000 of fringes and other employer costs.

A community with an effective property tax rate of 2 percent on full value would impose on the employer perhaps $600 a year per good job (allowing for some exemption from the tax base of such assets as inventory and liquid funds). Doubling the tax to 4 percent a year as a result of property tax classification could significantly affect the producer.

Taxes take from a business without directly giving it an equivalent. Taxes on a factory, warehouse, or office cannot help the user to perform the basic economic job of doing what people want or to perform that job more effectively. High rates of taxes, unlike prices of inputs, do not indicate the relative scarcities and productivities of various ingredients of production. Such taxation is simply a burden on capital. And capital (man-made forms as distinguished from land) has mobility. Movement is not always rapid, but the capacity for movement exists and—over the long haul—is effective.

Business taxes which are far above average inevitably reduce a community's ability to raise the productivity of its economy. While it is conceivable that governmental services for *businesses* in the area could be *sufficiently* better than those elsewhere to offset the higher taxes, how often will present and potential employers believe that their companies *as producing enterprises* get such benefits from relatively high local taxes or that high taxes really do provide services of equal benefit to operating companies?

Convenience

Productivity is vital for preserving and raising levels of living. Businesses are our major employers—the source of jobs. The taxes to support jobs in government must come largely from what the private sector produces.

Why, then, put discriminatory taxes on business property? Although we can easily jump to "politics" as the answer, let us look further, trying to identify reasons more specifically.

Corporations do not vote. The managers may, in fact, have little local political influence. Capital once sunk may not be movable for years. A steel mill or large assembly plant with "no place to go" can be an inviting target for tax discrimination. Convenience coupled with expediency will help to explain decisions.

Also, the burden is hidden—out of range of the awareness of those who ultimately pay it. What we see as taxes are rather different from what we see as prices and are generally viewed as annoyances instead of payments for services freely purchased. To dislike taxes is natural, but those we do not see will bother us less than those that are out in the open. The property tax element in what we pay at the checkout counter of the supermarket or at the clothing store never enters our consciousness. Any "animosity coefficient" over taxes which are embodied in prices is directed more toward business than toward government. Paying, say, $300 a year in hidden driblets may be less bothersome than having that amount added to housing costs. Is the property tax burden which is shifted to consumers in the prices they pay acceptably proportional and progressive or undesirably regressive? The facts are unclear. The actual burden of tax on properties used by a giant retail chain may, in fact, be somewhat regressive, but who voices objections to tax discrimination against property used by the chains by arguing that it eventually poses a regressive burden on low-income customers?

Putting Tax Burdens on Nonresidents

Voters may be impressed by another argument for tax discrimination against business property: *Persons outside the taxing jurisdiction bear some,* perhaps much, of the burden. A local factory may make parts to be assembled elsewhere into durable products which are eventually sold all over the country or world. The occupants of an office building may serve businesses and clients some distance away. A retailer's customers may include tourists and other persons from outside the community. Hotels and major public utility installations provide services for people who do not vote locally. If a community can force nonresidents to shoulder some of the tax, then, the argument goes, why not do so?

Or we may assume, as indicated by economic reasoning, that ultimately much, but by no means all, of the burden of property taxation on man-made capital rests on suppliers of capital rather than on consumers. Then to some extent investors outside the area who have supplied capital for business can be forced to pay part of the cost of local schools and streets and police. While open articulation of such goals may be rare in arguments for classification, attitudes may be influenced by some sense of such shifting. But what will be the long-run result?

Competition works. The overtaxed producer has trouble getting an adequate net yield. Capital for investment will flow to those areas where after-tax results are most attractive. Capital for new projects will, in effect, "vote with its feet," and any such result will hurt the high-tax area while favoring the less discriminating.

Classification against business property inevitably sends a signal to managers and investors about how decisionmakers in the state or locality think and feel. Is such a signal going to attract industry and help create conditions that will benefit residents and their children? Will it not rather lead investors and planners to fear that more anti-business discrimination, tax and nontax, may come later from persons with such frames of thought? The "business climate" is important, and it is the result of attitudes and actions of voters, lawmakers, and administrators. Such attitudes influence, for good or ill, the conditions for progress in a community.

Present Versus Future Homeowners

Over the long pull, would homeowners really get relief? This is less the case than popular discussion might suggest. Present owners do get a one-shot benefit, but future buyers and renters would receive little, perhaps almost nothing. Why? Because of *capitalization*, a basic principle of property taxation which has been widely recognized for decades.

The regular tax on a piece of property—adjusting for benefits of local spending of the revenue—affects the amount a buyer is willing to pay for the property. The lower the tax, the higher the price obtainable. Let us assume that a cut in the tax on houses is expected to continue indefinitely. Other things being the same, the reduction will raise the price of homes. Current owners experience capital gains. When today's owner sells, he can demand a price which capitalizes the worth of the tax reduction. Although the process is imperfect and although many factors influence housing prices, we cannot challenge the tendency for property tax changes to be reflected in the capital value of residential property.

The long-run result of classification will be to require new residents to pay higher prices for their housing—offsetting the lower tax. The interactions of the tax base and tax rate, of revenue and expenditure changes, and of business tax burdens cannot be predicted with accuracy. But one conclusion is beyond question: Owners at the time tax rates are reduced will obtain capital gains while future purchasers will be forced to pay higher prices for housing. Would not the inequity between generations properly deserve attention now? And criticism?

Concluding Comment

Although property taxation deserves attention, progress does not lie in changes which raise the relative burdens on productive enterprise. Proposals for classification which would shift burdens to the property of businesses would still tax people—there is no escaping this reality. Every change which raises the tax on business property invariably weakens the economic base of the communities doing so. The dangers are greatest where the levels of property tax are high. Capital tends to flow to locations more favorable to production, and, in the long run, the residents of areas seeking homeowner relief suffer.