



# Balancing Adequacy and Equity in Washington State's Property Tax

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WASHINGTON STATE  
**BUDGET  
& POLICY  
CENTER**

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# Executive Summary

Public education, fire protection, emergency medical services, parks, criminal justice, hospitals: all high-priority public services that are funded by the property tax. Washington can ensure adequate funding for these programs the public demands and address the inequities in the system.

## Adequacy and equity

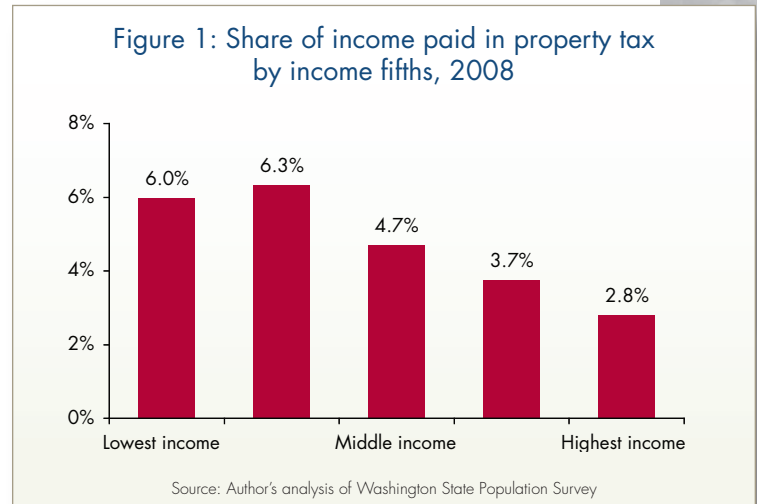
Too often, the conversation about property tax reform in Washington State bypasses two important principles of sound fiscal policy:

- **Adequacy:** Does the system produce adequate revenue to fund the services it is designed to pay for?
- **Equity:** Is the system fair, balancing taxation according to individuals' ability to pay? Does it exacerbate or alleviate inequities existing in the general economy?

These two principles are interdependent, and must be addressed together in any attempt at serious reform:

- A property tax structure that reaches adequate revenue levels only by requiring low and middle income households to pay more than their fair share of income while higher income households pay less than their fair share is doomed to failure. First, a taxing system that simultaneously funds equal access to public education, health care, and public safety and erects barriers to home ownership and general economic wellbeing is at cross purposes. Second, the broad middle class would not support a system that is made adequate at the expense of just rules.
- An equitable system that seeks to keep taxes low by inadequately funding public services would also be at cross purposes. The services funded by the property tax provide equal opportunity and are essential to the kind of society Washingtonians want to have. Inadequate levels of funding are fertile ground for tax increases that are not based on principles of basic fairness.

Washington's imbalanced state and local property taxes do not measure up on either of these goals. On the adequacy scale, tax limitations have sharply



curtailed the ability of our governments to do their essential jobs, with the worst effects growing every year. On the justice scale, lower income homeowners pay a much bigger share of their income in property taxes (6 percent) than higher income homeowners, (2.8 percent) (Figure 1).

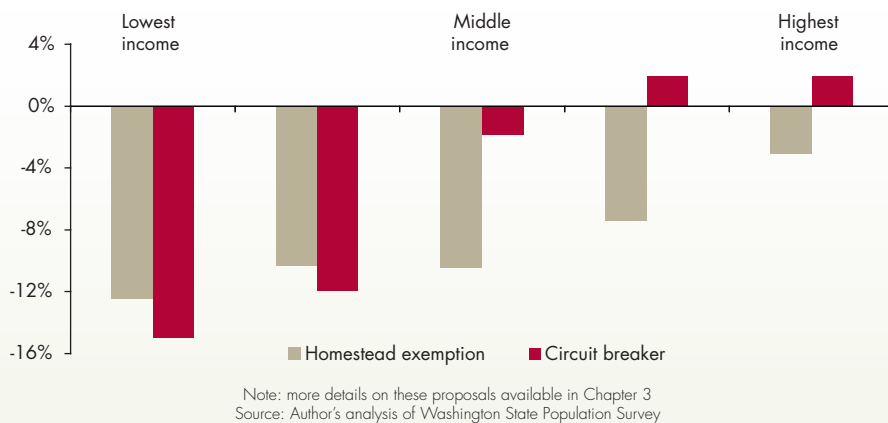
Policies that lead to both greater adequacy and improved equity are well established and in wide use in other states. Two primary examples, explored further in Chapter 3, are a homestead exemption and a "circuit breaker."

## Homestead exemption

A homestead exemption cuts taxes indirectly by reducing the taxable value of primary residences. While homestead exemptions generally reduce the taxable value of all homes by the same amount, the primary benefit of the tax reductions flows to those who are least able to afford paying property taxes. A homestead exemption already exists in the state, but it is limited to homeowners who are retired because of age or disability.

Under a \$50,000 homestead exemption (detailed further in Chapter 3), Washingtonians with the lowest incomes would receive a 12.5 percent tax cut,

Figure 2: Average tax cut by income level under two reform proposals, 2008



equitably reducing their taxes as a share of income to 5.2 percent (from 6.0 percent). The highest income households would, on average, receive a 3.1 percent tax cut (Figure 2).

Both the homestead exemption and circuit breaker would be financed with slight increases in property taxes on other types of property. However, a broad homestead exemption would cause revenue losses at the local level because of limitations on local tax rates, a situation that can—and should—be solved if a homestead exemption is pursued.

### Circuit breaker

Many states use a property tax “circuit breaker” to address inequity. Just as a circuit breaker in a home protects the electrical system from an overload that exceeds its capacity, a property tax circuit breaker would protect homeowners from a property tax bill that is too high relative to their household income. Tax credits become available to partially offset tax above a certain share of income.

Chapter 3 details one idea for a circuit breaker that provides a tax credit of up to \$1,000 to low and moderate income households when their property tax exceeds five percent of their income. The circuit breaker is more narrowly targeted to lower income households and could also be made available to renters (who pay property taxes indirectly). Under the circuit breaker outlined in Chapter 3, the lowest income homeowners would receive an average tax cut of 14.9 percent while the highest income households would see a slight increase of two percent in their tax bill (Figure 2).

### Tax limits

Chapter 1 takes a step-by-step overview of the current system. Every property tax dollar buys essential services in our communities: public schools, fire departments, libraries, emergency medical service, and more. More than half of all property tax collections (56 percent) go to public schools, our state’s constitutional “paramount duty.”

Services like public schools and public safety are always ranked high or highest in surveys of what taxpayers want for their money. Yet, the same surveys routinely find them dissatisfied with our current system of property taxation. Part of that dissatisfaction is born of the system itself, which is an amalgam of arcane assessment practices, complex rate structures, opaque spending priorities, and a tax that has to be paid in a lump sum. These factors, in combination with the inequities detailed in Chapter 3, have provoked broad efforts to limit property tax rates and revenue growth.

The result is a property tax now capped under the level necessary to keep promises about adequate public services to taxpayers. Figure 3 shows recent annual inflation in two areas that are closely related to the property tax—education and hospital care. While property taxes are capped at one percent growth per year, inflation in these essential services is rising much more quickly. Chapter 2 also spells out how rising demand for public services—growth in school age children and especially the elderly—will increasingly overwhelm a funding base that is illogically limited to one percent growth.

Such arbitrary limits on the ability of the state, local governments, and school districts to do their jobs weaken vital services -- and ignore rationally different abilities to pay property taxes by households at low and high income levels. In other words, they do nothing to uphold the principles of adequacy and equity.

And even though a series of tax limitations have won the day in recent decades, more restrictions still dominate the conversation about property taxes.

## Comparisons with other states

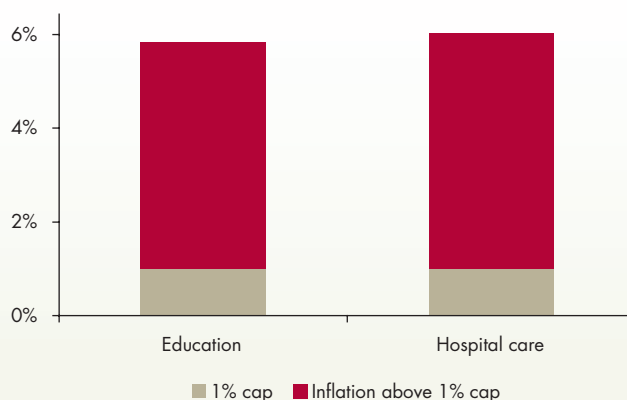
Washington's state and local property tax system is roughly average among states both in terms of property taxes as a share of personal income and reliance on property tax relative to other revenue sources.

However, Washington is out of step with other states with our heavy reliance on the general sales tax, lack of a personal income tax, and lack of property tax equalizers. This has resulted in an overall tax system that requires more out of lower income households relative to wealthier households than any other state in the nation. Property tax reformers must center on remedies to inadequacy and injustice in our tax structure as a whole.

## Structure of report

- **Chapter 1** provides an overview of Washington's property tax system and is designed to bring clarity to a complicated structure. It includes explanations of what the property tax pays for, how a property tax bill is determined, and how our property taxes compare with other states.
- **Chapter 2** discusses adequacy of the Washington property tax system. It describes the major ways in which taxes are restricted and the limited options available to local governments to avoid those limitations. It also includes reviews a perennially debated limitation—the assessment cap.
- **Chapter 3** focuses on equity. It reviews the history of Washington's property tax system and its consequences for fairness. Major options for reform are discussed, including a homestead exemption and circuit breaker. Data from the Washington State Population Survey are used to analyze these proposals.

Figure 3: Recent annual inflation in areas important to local government (1997-2006)



Source: Bureau of Labor Statistics





# chapter one

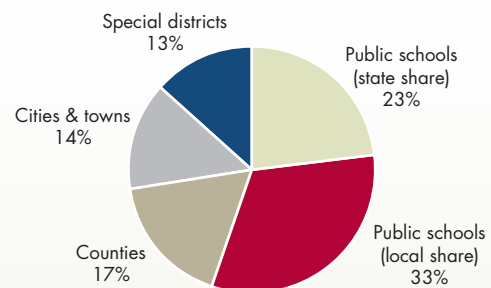
## Understanding the property tax

The property tax system is used in Washington State to fund important public priorities. Nearly half the revenue raised from the property tax goes to schools—constitutionally mandated to be the “paramount duty of the state”—with the remainder used to fund a variety of local government operations, including programs such as fire protection or public library service. The system is complex, with multiple overlapping entities raising revenue through levies on property. But the process of determining a property tax bill can be broken down into five steps. The level of Washington State property taxes is well in line with the national average as well as historical trends.

This chapter answers the following questions:

- What do property taxes pay for?
- How is a property tax bill determined?
- How does the Washington property tax bill compare historically and between states?

Figure 1A: Distribution of property taxes, 2005



Source: Department of Revenue

### What do property taxes pay for?

As shown in Figure 1A, property taxes are distributed between:<sup>1</sup>

- Public schools (56 percent)
- Counties (17 percent)
- Cities and towns (14 percent)
- Special districts such as fire and library districts (13 percent)

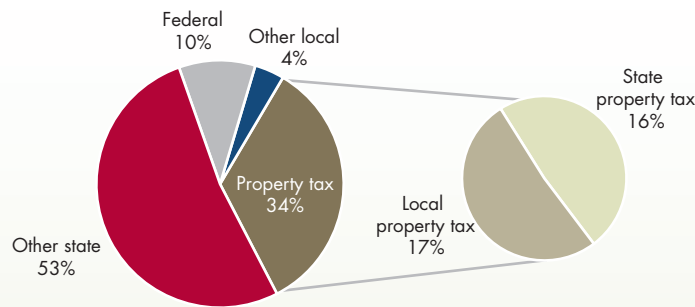
### Public schools

Property taxes are a core element of the revenue stream that funds Washington State’s public school system. Section I of Article IX of the State Constitution declares that:

*It is the paramount duty of the state to make ample provision for the education of all children residing within its borders, without distinction or preference on account of race, color, caste, or sex.*

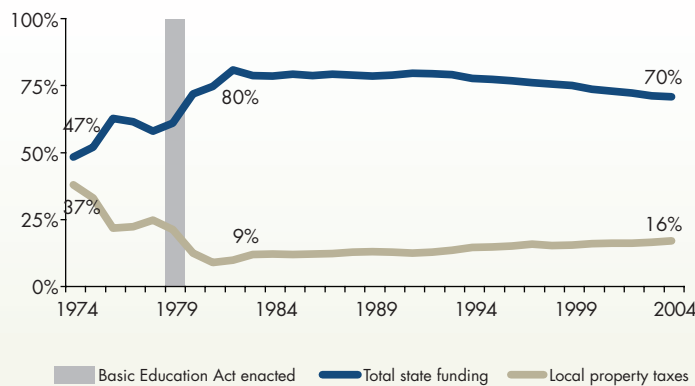
In 1976, voters had twice declined to approve a levy needed to adequately fund basic education in the Seattle School District. In response, the District brought a lawsuit against the state, arguing that

Figure 1B: Sources of general school district funding, 2005



Source: Office of Superintendent of Public Instruction, Department of Revenue

Figure 1C: Shifts in general school district funding between state and local property taxes



Source: Office of Superintendent of Public Instruction, Department of Revenue

the state was not meeting its “paramount duty.” The Supreme Court agreed and found that the reliance on local levies requiring voter approval did not provide a stable source of revenue that allowed school districts to consistently do their job. They directed the legislature to define “basic education” and to fully fund it. Lawmakers responded by passing the Basic Education Act of 1977 (BEA). The key provisions of the court decision and the legislation include:<sup>2</sup>

- A mandate for the state to take full responsibility for funding basic education.
- Requirements on school districts to provide minimum instructional hours and days, staffing ratios, and instructional content.
- Limits on school district levies.

The definition of basic education has been expanded over time through subsequent court decisions and legislation. Importantly, once a program is defined

as part of basic education, the state is required to continue funding it regardless of the state revenue situation.

The state itself is now the most significant source of funding for school districts, providing about 70 percent of school district operating budgets statewide (Figure 1B).<sup>3</sup> Roughly one-fourth of state funding for public schools comes from the state property tax. (By law, 100 percent of state property tax revenue is dedicated to public education. In practice, this requirement is largely irrelevant because state property taxes raise far less money than is necessary to meet the state’s obligation to the schools.)

State property taxes are deposited into the state general fund, but a portion is transferred to the Student Achievement Fund. In the 2003-05 biennium, 10.6 percent of state property taxes were transferred to the Student Achievement Fund.<sup>4</sup>

- The state General Fund is the principal state fund supporting government operations. Revenue from all major state taxes is deposited into this fund. Property taxes (after transfer to the Student Achievement Fund) make up 10.2 percent of state general fund revenues and are the third largest source of revenue (after the retail sales tax and the business and occupation tax).
- The Student Achievement Fund was created by Initiative 728 to finance certain education initiatives including class size reduction, extended learning opportunities, professional development for teachers, and pre-kindergarten assistance. In the 2003-2005 biennium, 81.1 percent (\$330 million) of the Student Achievement Fund revenue came from state property taxes, with the remainder from the state lottery.

School districts also have the authority to raise property taxes, but all levies from school districts must be approved by a supermajority of each district’s voters.<sup>5</sup> School district levies that are raised for general fund purposes are often called maintenance and operation levies (M&O) and are limited by law. Prior to the BEA, school districts relied heavily on voter-approved levies to fund their operation. In 1974, 37 percent of school district funding came from local property taxes, compared to 47 percent from the state (Figure 1C). The BEA went into effect in 1977 and the balance between state and local property taxes shifted significantly: the state paid for 80 percent of school district costs and only 9 percent came

from local levies by 1982. Since then, the share of education funding coming from local property taxes grew to 16 percent (2004), while the state share fell to 70 percent (see Figure 1B).<sup>6</sup>

In addition to M&O levies, school districts also must raise property taxes for capital projects, debt service on bonds, and to purchase new school buses. Between 75 and 80 percent of the funding for school capital projects comes from school district-raised property taxes.

### Municipalities

Property taxes are also a major funding mechanism for local governments. Washington State's 39 counties, 205 cities, and 76 towns are responsible for administering and providing substantial funding for vital public services. The largest categories of expenditures for county operating funds are:<sup>7</sup>

- Law and justice (36 percent)
- Health and human services (18 percent)
- Transportation (12 percent)

For cities and towns, the largest expenditures go to:<sup>8</sup>

- Law and justice (29 percent)
- Natural resources including parks and recreation (20 percent)
- Fire and emergency services (17 percent).

In fact, property taxes are the largest single revenue source for counties, contributing one-third of operating funds (Figure 1D).<sup>9</sup> The second largest source of revenues is transfers from state, federal, and other local governments. Cities and towns rely somewhat less on the property tax than do counties. However, the property tax is still the largest single source of revenue and makes up nearly one-fourth of operating funds.

Property taxes fund 18 percent of municipal capital and debt service funds as well. Municipal property taxes face limitations.

### Special purpose districts

Special purpose districts perform specific functions separate from municipal governments. Some of

Figure 1D: Municipal operating funds sources, 2005

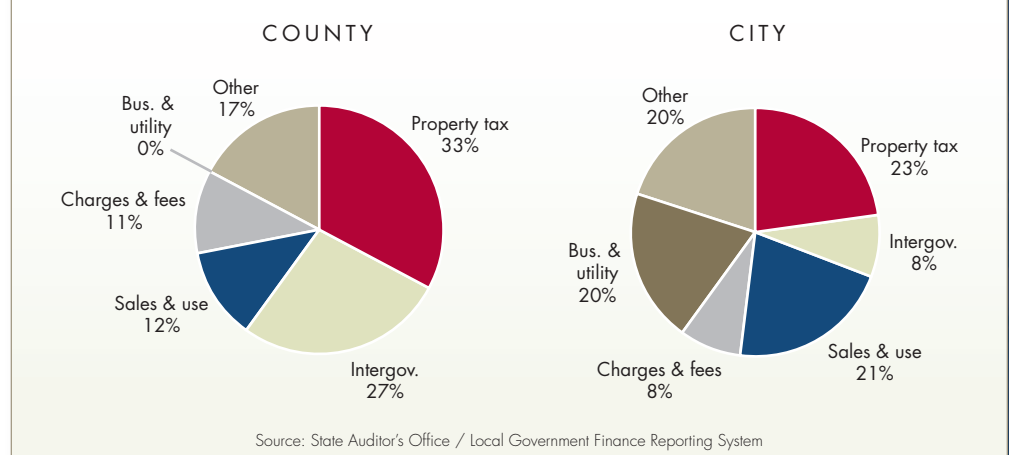
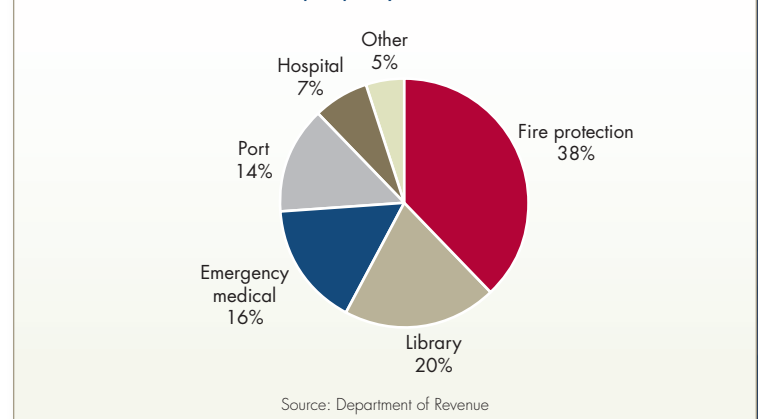


Figure 1E: Distribution of special purpose district property taxes, 2005



them fulfill the needs of residents living outside city and town boundaries. Others are countywide, cross county borders, or include cities and towns as well as unincorporated areas.

Thirteen percent of all property taxes in the state went to special taxing districts in 2005.<sup>10</sup> The largest special purpose districts by the amount of property tax raised are shown in Figure 1E: fire protection districts, library, emergency medical, port, and hospitals.<sup>11</sup> Other purposes served by special districts include (the following is a partial list):

- Arts, stadiums, and convention centers
- Cemeteries
- Conservation
- Flood control
- Irrigation
- Parks and recreation
- Rail
- Roads and bridges
- Sanitation and sewer
- Weed and pest control

## How is a property tax bill determined?<sup>12</sup>

### Step one: The taxing district creates a budget, approves it, and determines the levy amount

The property tax process begins when each taxing district—from the state government to mosquito control districts, there are over 1,700 districts in the state with the authority to raise property taxes to fund public services—develops a budget and determines the amount of revenue it will require in order to meet that budget.<sup>13</sup> (Each of these districts is limited in the amount of money they can raise by a number of restrictions.)

After determining its revenue needs, each district (other than the state) is required to hold a public hearing describing revenue sources and the proposed budget, specifically including any property tax revenue increases. All increases have to be authorized by separate ordinance. Some budgets require a vote of the people in order to pass.

If authorized (and determined to meet the requirements of the various limitations), the revenue proposal becomes a levy, which is the total amount of money that will be raised through property taxes in the coming year.

### Step two: The value of all taxable property in the district is determined

The county assessor has the responsibility of determining the value of all taxable property wholly located within the county. The state Department of Revenue assesses property that crosses county, state, or national borders.

The complex assessment process is beyond the scope of this report, but a few basics are important to understand:

- Generally, property is assessed at the fair market value of the property assuming that it is used in the most profitable way (called the “highest and best use”). Exceptions are made for agriculture land, open spaces, and timberlands.
- Residential property is assessed mainly on a sales approach, which means that the value is determined by looking at sale prices of comparable homes in the area.

- Commercial property is usually assessed by calculating the income potential of the property. This method is called the income approach.
- The cost approach, used primarily for manufacturing facilities, is based on the cost of replacing the property.
- Different counties revalue property on different cycles—from one to four years. Property owners in counties with a longer interval between revaluations can experience more uneven shifts in property tax bills.

### Step three: The tax rate for each district is calculated

Once the levy and the total assessed value are determined for each district, the tax rate is determined by dividing the levy by the total assessed value. Property tax rates are usually expressed as the tax per \$1,000 of property value. For example, a 1 percent tax rate would be expressed as \$10 per \$1,000 of value, or 10 mills. Tax rates are subject to restrictions on top of the restrictions placed on levy growth.

### Step four: The state equalizes the state tax rate

The State Constitution requires that the tax rate be uniform within any given tax district. The state property tax is levied on a single tax district (the state), so the tax rate must be equal throughout the state. This principle is complicated by the fact that assessments are not completely uniform across the state. While all county assessors are required to assess properties at market value, the reality is that there are different estimates of market value between counties. Most of the difference is due to the fact that counties reassess properties at different intervals (from one to four years). Another factor is the amount of data available. The Department of Revenue is responsible for remedying this problem by adjusting the tax rate for each county.

For example, consider two identical houses (House A & House B) both worth \$200,000 but located across county borders from each other. The county assessor in House A’s county assesses the property at \$200,000, the fair market value. Across county borders, the other county assesses House B at \$190,000 because of a different valuation cycle or lack of data. With equalization of the state property tax rate, the two homeowners with identical houses will end up paying different taxes, violating the constitution (see

Figure 1F). Through the equalization process, the state tax rate is raised slightly for House B's county so that both owners pay the same tax.

### Step five: The tax rates are combined for each Tax Code Area

Since many of the 1,700 districts with the authority to levy property taxes overlap, there are over 3,000 areas in the state with unique combinations of property tax districts, called Tax Code Areas (TCA).<sup>14</sup> The total tax rate in each TCA is determined by adding up all the tax rates for the taxing districts into which the TCA falls.

It is helpful to use an example to understand this. Figure 1G shows how property tax districts overlap in Northwest Yakima County.<sup>15</sup> Tax Code Area (TCA) #407 is highlighted in red. This area is taxed by the state, the county, and special districts. Figure 1H shows how the total tax rate of \$12.7 per \$1,000 of value breaks down into the various taxing districts, all of which provide important public services.

All of Yakima County is also in the Yakima Emergency Services District and Yakima Flood Control District. In addition to those districts, TCA #407 also lies within the intersection of the Selah School District, Yakima Fire Protection District #2, Mosquito Control District #1, the County Roads District, and the County Library District.

The tax bill for a household in TCA #407 is the total of each of the rates of the different districts in which they live, divided by \$1,000 and multiplied by their assessed home value. A household with a \$200,000 house would therefore pay \$1,430 for public education, \$423 for roads, and so on, adding up to a total of about \$2,500 for a house assessed at \$200,000 (Figure 1H).

### How does the Washington property tax bill compare historically and between states?

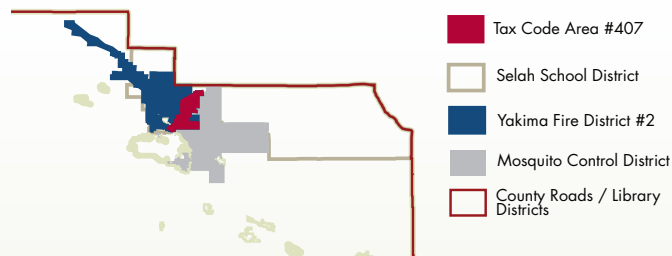
In order to understand the recent historical trends in the level of property taxation, the Washington property tax bill needs to be put into perspective. This can best be done by comparing total property taxes in the state over time to 1) the total assessed property value, and 2) total personal income.

Figure 1F: Equalization of county assessment practices

	House A	House B
<i>Property value</i>		
Market value	\$200,000	\$200,000
Assessed value	\$200,000	\$190,000
<i>Without equalization</i>		
State property tax rate	\$2.50	\$2.50
Property taxes owed	\$500	\$475
<i>With equalization</i>		
State property tax rate	\$2.50	\$2.63
Property taxes owed	\$500	\$500

Source: Author's analysis

Figure 1G: Yakima County Tax Code Area #407



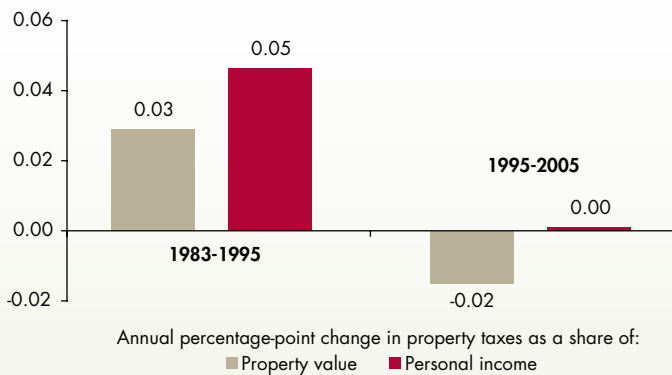
Source: Author's analysis

Figure 1H: The property tax bill for Yakima County Tax Code Area #407

	Property tax per \$1,000 of value	Annual Amount Owed on a \$200,000 house	Percent of total
<i>Schools</i>			
State School Levy	2.5	\$501	19.7%
Selah School District	4.6	\$929	36.6%
<i>County</i>			
Yakima County	1.7	\$339	13.4%
County Emergency Services	0.2	\$47	1.9%
Yakima County Flood Control	0.1	\$19	0.7%
Yakima County Road	2.1	\$423	16.7%
<i>Other</i>			
Fire Protection	0.9	\$185	7.3%
Library	0.5	\$95	3.7%
Mosquito Control	0.0	\$0	0.0%
<b>Total</b>	<b>12.7</b>	<b>\$2,538</b>	<b>100.0%</b>

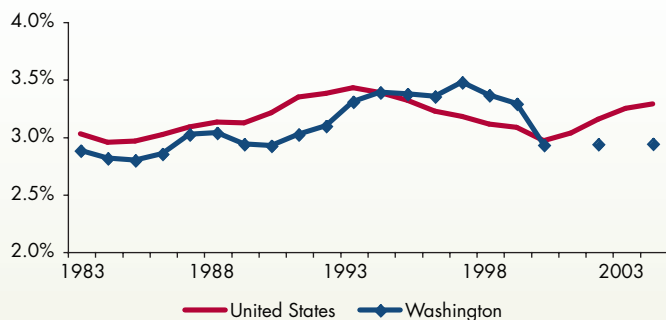
Source: Yakima County Department of Property Assessment and author's analysis

Figure 1I: Changes in property taxes in perspective, 1983-1995 and 1995-2005



Source: Office of Superintendent of Public Instruction, Department of Revenue

Figure 1J: Property taxes as share of personal income in Washington and United States, 1983-2005



Source: Tax Policy Center, U.S. Census Bureau. U.S. Bureau of Economic Analysis

Changes in the state's property tax rate depend on the interaction between the assessed value of the property and the total taxes levied. If value and levies rise or fall at the same rate, the tax rate will remain the same. Between 1983 and 1995, levies grew more quickly than assessed value. The result, shown in Figure 1I, was that the tax rate rose—from about \$10.10 per \$1,000 of property value to about \$13.50 (or about 30 cents per year per \$1,000 of value).<sup>16</sup>

Another way of analyzing changes in property tax is by comparing it to a measure of income such as total state personal income, as measured by the Bureau of Economic Analysis.<sup>17</sup> When measured against personal income, the growth in property taxes was faster than the growth in personal income from 1983-1995.

In the last decade, however, property taxes have grown less quickly than property values (Figure 1I). The property tax rate fell between 20 and 30 cents a year per \$1,000 of property value. Over the same period, taxes grew at nearly the same rate as personal income, suggesting on both measures (with the limitations mentioned) that the ability of taxpayers to pay the property tax bill has not worsened and may have improved over the last decade.

Figure 1J shows how the property tax bill as a share of personal income has compared to the national average over the last two decades.<sup>18</sup> Throughout this period, the Washington State tax bill has been very similar to that of the nation as a whole. In the first period (1983-1995), Washingtonians paid a somewhat lower share of income in property taxes. We rose over the national average for a few years, before falling below it again.

In order to make taxes comparable across states, the Census Bureau must group some taxes that are viewed separately in some states, but not so in other states. The key issue in this case is that the Census Bureau includes motor vehicle excise taxes (MVET) in state property taxes.<sup>19</sup> The Washington MVET, which was separated from the property tax decades ago, grew more quickly during this period until the state portion was essentially repealed effective January 2000. It is likely that the MVET accounts for a large share of the differences between Washington State and the nation as a whole.

Overall, Washington's property tax bill is very near the national average and has not changed substantially over the past decade when compared to personal income and has fallen during the same period as a share of property value.

## Endnotes

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14. Department of Revenue, Property Tax Statistics 2006, Table 11, [http://dor.wa.gov/content/statistics/2006/Property\\_Tax\\_Statistics\\_2006/default.aspx](http://dor.wa.gov/content/statistics/2006/Property_Tax_Statistics_2006/default.aspx)
15. Map boundary files come from Department of Revenue, <http://gis.dor.wa.gov/taxratefinder/ptdownloads.aspx>. Data on Yakima taxing districts are from Yakima County Department of Property Assessment, <http://www.co.yakima.wa.us/assessor/tca/tca.asp>.
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17. Bureau of Economic Analysis. Regional Economic Accounts. <http://bea.gov/regional/spi/>
18. State & Local Government Finance Data Query System. <http://www.taxpolicycenter.org/slf-dqs/pages.cfm>. The Urban Institute-Brookings Institution Tax Policy Center. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments.
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# chapter two

## An adequate property tax

The public conversation about property taxes commonly focuses on limiting them. Far less often does the dialogue include the indispensable role property taxes play in funding schools, libraries, roads, and public safety. The property tax is widely known as an unpopular tax; over the years, numerous limitations have been placed on the ability of governments in the state to raise the funds needed to pay for public services that citizens want the most. Further limitations are frequently under consideration. These restrictions need to be considered within a frame of overall revenue adequacy. Unfortunately, that has not been the case. Limitations on property taxes have proven problematic for education and local districts, a trend that will grow in coming years.

This chapter answers the following questions:

- How do property tax limits affect revenue adequacy?
- What is the “ten-dollar limit” on tax rates?
- What is the one percent limit on levy growth?
- What options do districts have to raise needed funds above the limits?
- What is an assessment cap?

### How do property tax limits affect revenue adequacy?

Property taxes are an important source of revenue for programs and public structures that residents care about such as hospitals, schools, bridges, police and fire protection, parks, and public health. These taxes also contribute stability to the tax base, because the value of property tends to be less susceptible to economic fluctuations than retail sales or incomes.

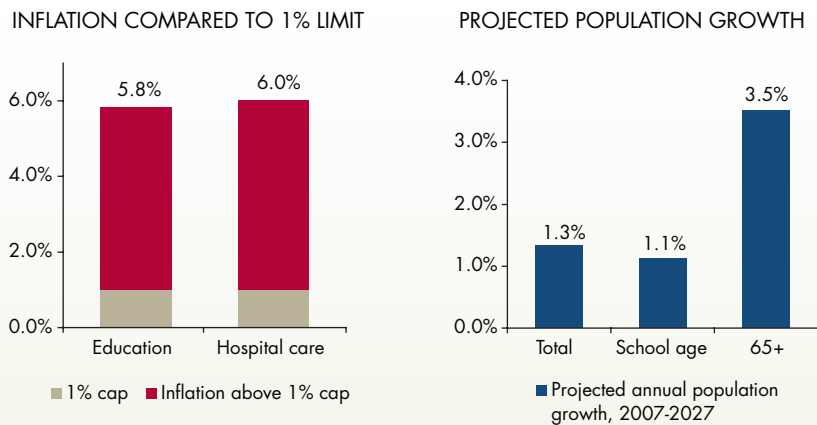
Despite these advantages, property taxes are widely unpopular, and are often cited as the most unpopular tax in polls. The reasons for this include:<sup>1</sup>

- It is a visible tax, often paid in a substantial lump sum. While many property owners have escrow accounts from which property taxes are paid, they are often quite sensitive to the effect property taxes have on their mortgage payments--often the most expensive monthly bill.
- It is complicated. In Washington State, there are over 3,000 unique areas in the state with different taxing structures. Appraisal and valuation methods are arcane. Finally, property tax bills tend to be complicated and difficult to read.
- Importantly, there is sometimes little connection between the value of a parcel, the property tax that people are required to pay on it, and their ability to pay.

For these reasons, property taxes have been under attack. A “tax revolt” led to a reduction of property taxes in Washington by half in 1932, and the anti-property tax movement has reappeared almost every decade since. The most recent successful effort to sharply limit property taxes in Washington State was in 2001, when Initiative 747 was passed.<sup>2</sup>

There are two big problems with tax limitations such as I-747. First, they sharply limit the ability of government to fund the services people care about without replacing the lost revenue with a different form of taxation. The Washington State Tax Structure Study, a government sponsored study undertaken by academic experts and elected leaders, recognized the

Figure 2A: Growth in cost factors for local government



Source: Bureau of Labor Statistics, U.S. Census Bureau

left shows recent annual average inflation (1997-2006) in areas that are important to local government programs—education and hospital care.<sup>5</sup> All of these have grown in price far above the one percent limit set by I-747. The graph on the left points to another key cost factor for government—population growth in key groups. The Census Bureau projects that the population of the state will grow an average of 1.3 percent over the next 20 years.<sup>6</sup> The growth in the

65 and older population is expected to rise at 3.5 percent annually.

Population growth and inflation growth do not fully capture the rate at which the growing population will require government services. They also miss the effect of future policy changes. Residents and policymakers are demanding a stronger education system, better access to child care, and reform of a health care system that leaves many without access to affordable quality care. These add to the requirements placed on a tax system that is hampered by multiple levels of restriction. Inflation trends and looming population growth make clear that the current restrictions on property taxes will make it impossible to meet future demand for important services.

unpopularity of the tax and recommended cutting the property tax, but replacing that revenue with a state income tax.<sup>3</sup>

Secondly, limitations do nothing about the unbalanced characteristics of the system—the fact that lower income households pay a much higher share of income in taxes than wealthier households. This unbalanced and regressive distribution of taxing responsibility is greater in Washington State than any other state.<sup>4</sup>

Quantifying the effect that property tax limitations have had on state and local government is difficult because it's not clear how to measure how much revenue governments would have raised in the absence of these limitations.

While there is anecdotal evidence that I-747 and other limitations have had significant negative effects, the impact of I-747 has been dampened by the following trends:

- Quickly rising property values and substantial new construction (in some parts of the state).
- A fairly strong economy with controlled inflation.
- Leftover revenue authority from pre-I-747 years.

There is certainly no guarantee that any of these trends will continue—leftover revenue authority from past years obviously will not. For this reason, the true effects of I-747 will likely accumulate over time.

Figure 2A demonstrates how property tax limitations hurt the ability of government to adequately respond to the needs of their constituents. The graph on the

## What is the “ten-dollar limit” on tax rates?

Since the 1930s, the state has placed a limit on the total tax rate that could be levied without direct voter approval. In 1972, voters lowered that limit further, where it has remained since. The limit can be expressed as one percent or \$10 for each \$1,000 of assessed value. Subsequent legislation has divvied up the \$10 between the various taxing districts in the following way (Figure 2B):<sup>7</sup>

- State school levy—\$3.60
- Counties—\$1.80
- Cities, county roads, and junior taxing districts—\$4.10
- Other—\$0.50

School districts receive no authority for taxes under the ten-dollar limit—putting large shares of their budgets on the ballot every few years.

The \$4.10 for cities, county roads, and junior taxing districts can be split up in one of three ways (Figure 2A):

- For areas outside city and town boundaries, county roads receive \$2.25 and junior taxing districts receive \$1.85.
- For cities and towns that provide fire protection and library service, the city or town receives \$3.60 and junior taxing districts receive \$0.50.
- For cities and towns where fire protection and library service is provided by a special district, the city or town receives \$3.375 and the junior districts receive \$0.725.

The “other” category that receives \$0.50 of the \$10.00 includes open space preservation, emergency medical services, affordable housing, metropolitan parks, criminal justice, and ferry services. All other special taxing districts (see Chapter 1) are considered junior taxing districts.

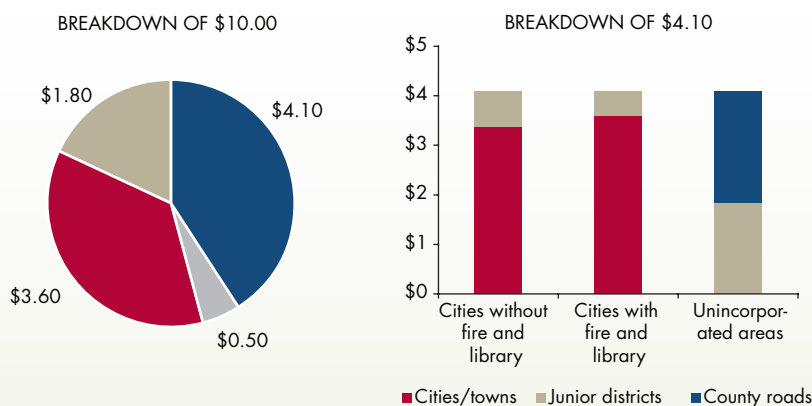
If the levies raised by cities and towns, counties, and junior districts exceed \$5.90, the levy amounts within the \$5.90 limit are lowered according to a prioritized list. For example, parks and recreation levies would be lowered before hospital levies and the municipal governments would be the last to be lowered. Limits are set on how far the lower priorities can be reduced to pay for the higher priorities.

## What is the one percent limit on levy growth?

In addition to limits on tax rates, there are also limits on levy growth. Generally, a regular levy in any given year cannot be higher than the highest levy in the most recent three years multiplied by a limit factor.

Prior to 2002, the limit factor was the lower of 106 percent or 100 percent plus the rate of inflation.<sup>8</sup> This meant that if the highest levy in the previous

Figure 2B: Breakdown of “ten-dollar limit” on regular property tax rates



Source: Department of Revenue, Revised Code of Washington

three years was \$1 million, the maximum levy in the current year could be no higher than \$1 million multiplied by 106 percent, a growth of \$60,000.

In November 2001, voters passed Initiative 747. This initiative dramatically lowered the limit factor to the lower of 101 percent or 100 percent plus the rate of inflation.<sup>9</sup> In the example above, the levy would only be allowed to grow by \$10,000, assuming inflation was at least one percent.

If there was no levy growth limit, districts would have the authority to raise or lower levies depending on local need. Levies would be allowed to grow to meet new needs while tax rates remained the same. Limits on the growth of levies tend to force tax rates to fall. Without a levy growth limit, the tax rate could stay the same and the levy would rise by the growth in appreciation. The taxing districts would also be able to raise or lower the tax rate to meet their budgets. If the total property value grew by more than one percent, the limit requires the tax rate to be lowered to keep revenue growth under the prescribed cap.

There is a misperception that the one percent growth limit applies to each individual property tax bill. This may be why some voters support this type of limitation. This is not the case unless every property in the district was worth the same in the previous year and appreciated at exactly the same level. In actuality, individual tax bills can rise above the one percent if the property rises in value relative to other properties or started out at different values, which is always the case.

Figure 2C: Hypothetical increase in individual tax bills under 1% levy growth limit

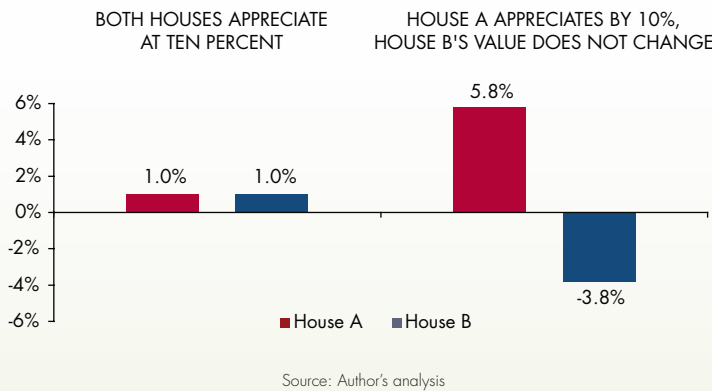


Figure 2D: Effect of 1% levy growth limit on Lincoln County, 2005

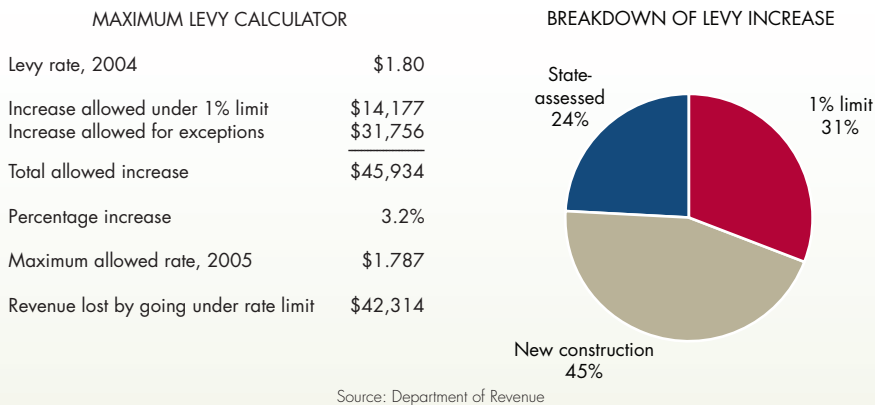


Figure 2C illustrates this with a hypothetical taxing district with only two houses. Both houses were worth the same in the previous year and were taxed at \$10 per \$1,000 of value. In the first scenario, both houses appreciated by 10 percent. Under the one percent growth factor, the tax bill of both houses would rise by one percent. In the second scenario, House A still appreciates by 10 percent, but the value of House B doesn't change. The total tax bill between the two houses would still rise by only one percent, but House A's tax bill would rise by 5.8 percent, while House B's bill would fall by 3.8 percent. However, both houses would receive an equal reduction in their bill compared to what it would have been if the tax rate had been allowed to stay the same—3.8 percent.

The limit factor does not apply to the revenue from new construction, property improvements, construction of personal wind turbine facilities,

and growth in the value of property assessed by the state.<sup>10</sup> The revenue that would have been raised from these properties by taxing them at the previous year's rate is added to the maximum levy. Because of this provision, the rapid growth in new construction since the passage on I-747 has somewhat ameliorated the effects of the initiative in some areas of the state.

The experience of Lincoln County is illustrative of the impact of one percent limit and how taxing districts can lose taxing authority because of the combination of property tax limitations (Figure 2D). When determining its levy for 2005, the County took into account the following numbers:<sup>11</sup>

- The highest previous levy was \$1,417,719. The one percent limit allows the county to add a levy equal to 101 percent of that amount, or an additional \$14,177 in revenue.
- New construction added \$11.6 million in property value. This value is allowed to be taxed at the \$1.80 level, raising \$20,881 in taxes.
- State-assessed property grew by \$6.0 million. This value is also allowed to be levied at the \$1.80 rate, or an additional \$10,875 in revenue.
- The maximum levy for 2005 is therefore  $\$1,417,719 + \$14,177 + \$20,881 + \$10,875 = \$1,463,653$  (an increase of \$45,934 in revenue).

In order to meet the growing needs of county residents, Lincoln County levied the maximum levy in 2005. The one percent levy growth limit and the \$10 rate limit came into conflict. The calculated tax rate for the maximum levy equaled \$1.787, which meant that the county could not levy at its maximum tax rate of \$1.80, losing over \$42 thousand in levy authority.

The pie chart in Figure 2D shows the breakdown of the levy increase between the basic one percent limit and the exceptions made (new construction and state-assessed property). Only 31 percent of the increase comes from the 1 percent growth in the highest previous levy. Forty-five percent of the increase came from new construction, although it should be remembered that new construction reflects additional demand for the services local governments provide.

## What options do districts have to raise needed funds above the limits?

### Banked capacity

The drafters of the state's levy growth limits were concerned that the limit factor would create an incentive for districts to continue increasing levies at the maximum even if the needs of the district did not require it. By not going up to the limit, the base for future years would be lower.

For this reason, districts are able to access “banked capacity.”<sup>12</sup> Banked capacity is the amount of additional money the district could have raised if it had maintained maximum levy growth over the years. The ability to bank new capacity has been sharply limited with the adoption of the one percent levy growth limit.

### Levy lid lift

Under certain conditions (including exhaustion of banked capacity), a district can raise its regular levy (note the difference between regular and special levies below) over the one percent limit factor by a simple majority vote of the people.<sup>13</sup>

There are two main types of levy lid lifts:

- Temporary lifts raise the levy above the one percent growth. However, when the ballot measure expires, the base is recalculated as if the lid lift never happened. Counties, cities, and towns are able to raise levies above the lid lift for each of up to six years before the base is recalculated. Other districts are able to approve levy growth above one percent only in the first year of up to six years before the base is recalculated.
- There are also permanent levy lifts. In a way, this is a misnomer because the district cannot raise the growth limit in a single vote to above one percent for perpetuity. What makes it permanent

is that the base is recalculated so that future levies are allowed to rise at one percent over the new levy amount. Counties, cities, and towns are able to raise permanent levy increases of above one percent for each of up to six years. Other districts may pass a permanent lid lift for only one year, after which the levy growth limit returns to one percent.

Levy lid lifts are restricted by the ten dollar limit—levies that would require a tax rate of above the maximum rate are not allowed. However, levy lifts are a useful way to allow districts to return to their maximum rate for a limited time. As noted above, under the one percent growth limit districts cannot keep their tax rate at the maximum when property value is appreciating above one percent. However, this is only a temporary solution and requires districts to continue going back to the voters with further requests for lid lifts.

### Special levies

The ten dollar limit can also be raised by a vote of the people, but it requires a supermajority vote.<sup>14</sup> The number of affirmative votes must be equal or greater to both a) 60 percent of those voting on the measure, and b) 24 percent of the voters in the last general election. Levies raised in this way are called “special” or “excess” levies and are approved in terms of the total dollar amount to be raised.

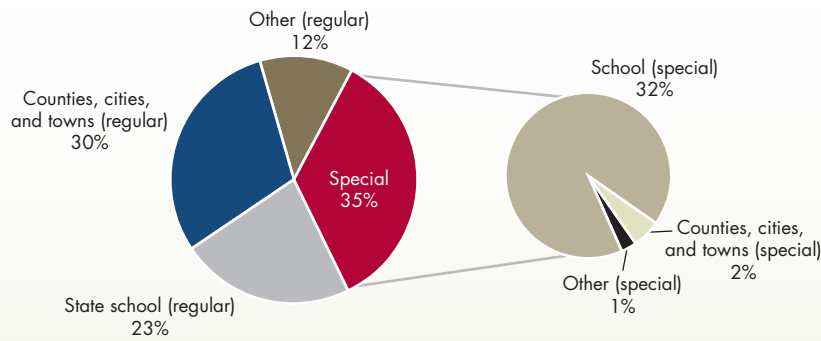
Special levies are limited to a certain number of years, after which time the districts must go back to the ballot to raise needed funds. The time limit is generally only one year with the following exceptions:<sup>15</sup>

- For school district and fire district operating budgets, the limit is one to four years.
- For school district and fire district capital projects, the limit is up to six years.
- Bond retirement levies can be approved for up to 30 years.

Special levies made up 35 percent of total levies statewide in 2005 (Figure 2E). Ninety-one percent of special levies were for school districts.<sup>16</sup>

As noted above, school districts are given no regular levying authority. Therefore, in order to raise funds beyond what the state and federal government sends, school districts rely wholly on special levies. Over the last quarter-century the share of school funding

Figure 2E: Distribution of property taxes by regular and special levies, 2005



Source: Department of Revenue

Figure 2F: Hypothetical effect of assessment cap on two different houses



Source: Department of Revenue

coming from school district special levies has risen steadily. While it has not reached the levels of the mid-1970s, the restrictions on taxing authority that prompt an over-reliance on special levies was the instigating factor of the lawsuit that led to the passage of the Basic Education Act of 1977 (see Chapter 1).

### What is an assessment cap?

Of the three key components of the property tax system, Washington State caps two: levies and tax rates. The third, property values, are not capped in the state, although proposals to implement such a restriction are perennially under discussion.

As noted above (see Figure 2C), even with capped rates and capped levies, the relative growth in individual tax bills depends heavily on the growth

in assessed value. The property tax system is designed to raise taxes in direct proportion to growth in property value. Growth in property value does not perfectly track the property owner's ability to pay additional taxes, but there is a relation. Quickly growing value can translate into additional income upon selling the home, and the ability to use the additional equity to borrow against.

An assessment cap would cap the growth in annual assessments to a certain percentage. Such a policy would shift taxes from properties experiencing rapid growth in value to properties that are not growing as quickly in value. Figure 2F illustrates the effect of this with a hypothetical taxing district with two properties. The first property is growing in value 10 percent each year, while the second property is growing at only 3 percent

per year. If an assessment cap is placed at five percent but the tax rate remains the same, the property owner with the growing wealth would receive a growing tax cut each year that would be equal to the tax growth for the other property owner.

Because the assessment cap would decrease total assessed value, a higher tax rate would be required in order to raise the same levy that would be raised without an assessment cap. This could result in significant revenue loss if the new rate would be above the district's statutory rate limit. The revenue loss due to the assessment cap would grow over time.

## Endnotes

1. For example, see Cauchon, Dennis. 2006. "States Attack Property Taxes." USA Today, August 24.
2. See Revised Code of Washington 84.55.005 and 84.55.0101. For the full text of I-747, see <http://www.secstate.wa.gov/elections/initiatives/text/i747.pdf>. On June 13, 2006, I-747 was declared unconstitutional in the Superior Court for King County (No. 05-2-02052-1 SEA). The decision was under appeal to the Washington State Supreme Court at the time this report was published.
3. Washington State Tax Structure Study Committee. Tax Alternatives for Washington State: A Report to the Legislature. [http://dor.wa.gov/content/statistics/WAtaxstudy/Final\\_Report.htm](http://dor.wa.gov/content/statistics/WAtaxstudy/Final_Report.htm)
4. McIntyre, Robert et al. 2002. Who Pays? A Distributional Analysis of the Tax Systems in All 50 States 2nd Edition. The Institute on Taxation and Economic Policy. <http://itepnet.org/whopays.htm>
5. See Bureau of Labor Statistics. 2007. Consumer Price Index-All Urban Consumers. <http://www.bls.gov/cpi/home.htm>. The Consumer Price Index measures changes in costs to consumers, not governments. Used as a measure of inflation faced by state and local government, it should be considered a conservative estimate.
6. Census Bureau. 2005. State Interim Population Projections by Age and Sex: 2004 – 2030. <http://www.census.gov/population/www/projections/projectionsagesex.html>
7. Revised Code of Washington, 84.52, multiple sections.
8. This limit on levy growth would go back into effect if I-747 was upheld as unconstitutional in the State Supreme Court.
9. In the unlikely case that inflation is below 1 percent, there are two exceptions. Districts with fewer than 10,000 people may always go up to 101 percent. Other districts (aside from the state) may go up to 1 percent by approval of the district's legislative authority.
10. Revised Code of Washington, 84.55.080. Inter-county, interstate, and foreign utility and transportation companies are valued and assessed by the state Department of Revenue.
11. Data from the state Department of Revenue. See [http://dor.wa.gov/content/statistics/stats\\_proptaxstats\\_LevyDetail.aspx](http://dor.wa.gov/content/statistics/stats_proptaxstats_LevyDetail.aspx).
12. Revised Code of Washington, 84.55.092.
13. Revised Code of Washington 84.55.050
14. Revised Code of Washington 84.52.052, Washington State Constitution Article VII, section 2(a).
15. Revised Code of Washington 84.52.053, 84.52.130 Washington State Constitution Article VII, section 2(a).
16. Department of Revenue, Property Tax Statistics 2006, Table 9, [http://dor.wa.gov/content/statistics/2006/Property\\_Tax\\_Statistics\\_2006/default.aspx](http://dor.wa.gov/content/statistics/2006/Property_Tax_Statistics_2006/default.aspx).





# chapter three

## An equitable property tax

Equity is as important to property tax reform as adequacy—and just as infrequently addressed.

The broad (and expensive) property tax limitations in recent years have ignored the fact that lower income homeowners pay a larger share of their incomes in property taxes than do higher income property owners. Inequity pervades Washington’s state and local tax system, giving it the dubious distinction of being the most regressive in the nation. Any discussion of property tax—in fact any tax discussion—should include ways to improve fairness. Other states have addressed inequities in the property tax with programs such as a homestead exemption and “circuit breaker.” This chapter uses data from the Washington State Population Survey to demonstrate the effects such programs could have in our state. As well, we review constitutional barriers to adopting them.

This chapter puts the property tax conversation into the context of the following questions:

- How does the current system address equity?
- How can adequacy and equity be balanced?
- What would the effects of a homestead exemption be?
- What would the effects of a circuit breaker be?
- How are renters affected by the property tax?

### How does the current system address equity?

#### The uniformity clause and tax equity

Over a century ago—when the current version of the state constitution was drafted—property taxes were the primary source of revenue for state and local governments. In a largely agrarian economy, property was the key economic asset. While incomes were volatile and unpredictable, ownership and value of property were more stable and closely linked to economic wellbeing. In a system where levels of property ownership were fairly precise indicators of relative wealth, reliance on property tax made sense as a stable revenue source and a fair way of dividing up the costs of government.

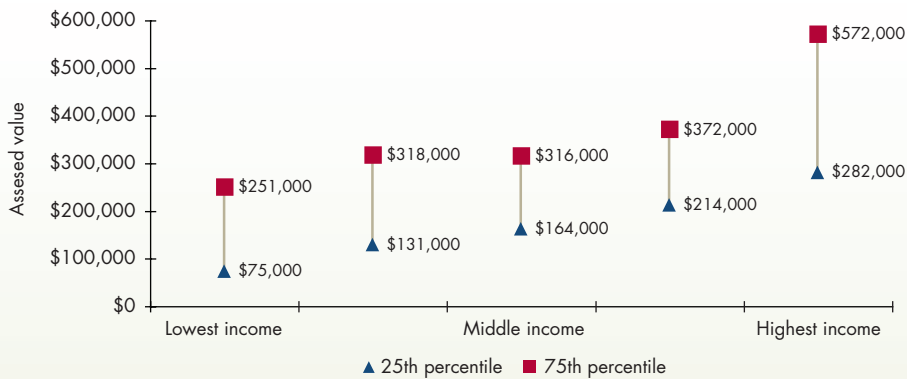
The drafters of the 1889 state constitution were concerned about special exemptions from the property tax for anyone from railroad corporations to widows and orphans. This prompted them to establish a constitutional principle of uniformity—that every parcel of property within any given taxing district would be assessed and taxed at the same rate. This would apply to commercial and residential property as well as farmlands.

Current constitutional language (Article VII, Section 1) states:<sup>1</sup>

*All taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax . . . All real estate shall constitute one class.*

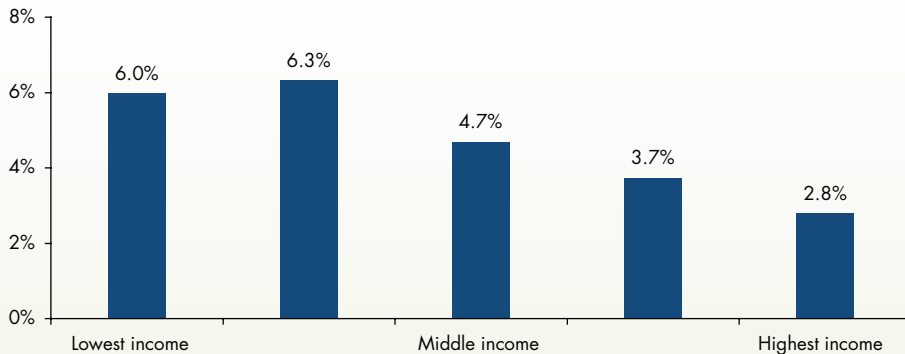
This clause aimed to ensure that the tax system would meet a relatively crude definition of fairness: that no property would be taxed differently than any other property. An equally important and commonly accepted definition of tax equity is that used by the Washington State Tax Structure Study: that “the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to pay the tax.”<sup>2</sup>

Figure 3A: Range of assessed values by income level, 2008



Source: Author's analysis of Washington State Population Survey

Figure 3B: Share of income paid in property tax by income fifths, 2008



Source: Author's analysis of Washington State Population Survey

In the present day, ownership of property remains an important indicator of economic well-being, but does not correlate perfectly with ability to pay property taxes. A property tax bill that is set solely with regard to property value can become a barrier to home ownership. Figure 3A shows the range of property values at different income levels. For each income level, the middle 50 percent of assessed values are between the higher point and lower point of each line. While property value does grow with income, it does not do so evenly. There is not much variation in property value among the middle 60 percent of the income distribution, suggesting that many households have relatively high property values when compared to their income level. (The richest 20 percent have considerably higher home values, in line with higher incomes.)

In addition, nearly all wealth owned by most Washingtonians (their houses) is taxed by the prop-

erty tax, but much of the wealth owned by the richest residents—including stocks, bonds, savings accounts and so on—is exempted from the property tax.

The result is that lower income property owners in Washington State pay more than twice as much, measured as a share of their income, in property taxes than do the wealthy. Owners in the poorest one-fifth (by household income) pay 6.0 percent of their income in taxes on average, compared to 2.8 percent for the richest one-fifth (Figure 3B). (The poorest 20 percent pays less as a share of income than the next 20 percent because of the senior exemption program, which has a significant effect on the poorest group.)

## Washington State tax history

The constitutional uniformity clause has consequences beyond just the property tax. In

fact, the clause (and its interpretation by the courts) has perhaps exerted more influence over tax policy in Washington State than any other legal principle. It is a key to why the essentials of the state's tax system have not changed in the last 70 years to keep up with changes in the economy.<sup>3</sup>

In 1932 two ballot initiatives passed overwhelmingly: one to limit the property tax and one to pass a graduated income tax. The income tax was suspended during a court challenge, leaving the state with an inadequate property tax and no replacement for the revenue lost. In response the legislature passed a temporary business gross receipts tax (the business and occupation tax, or B&O), which was also challenged in court. In two separate court cases, the B&O tax was upheld, but the income tax was ruled a property tax that did not pass muster under the uniformity clause. In 1935, the legislature enacted, among other

tax changes, a retail sales and use tax. With some minor adjustments, this is the system that has remained in place through the present day.

The key differences between Washington State and most other state and local tax systems is our heavy reliance on general sales taxes and our lack of personal and corporate income taxes (Figure 3C). The general sales tax makes up 45 percent of state and local taxes in Washington State, compared to 12 percent in the nation. Property taxes are roughly the same as a share of general revenue taxes, as are select sales taxes (which include the B&O tax in Washington State).<sup>4</sup>

Washington's over reliance on general sales tax and lack of an individual income tax have made Washington's tax system the most regressive in the nation. According to a 2002 study by the Institute for Taxation and Economic Policy, the poorest one fifth of state residents pay more than five times as much as the top one percent of earners, measured as a percentage of income.<sup>5</sup> No other state gives this level of preferential tax treatment to the wealthiest at the expense of its lowest income households.

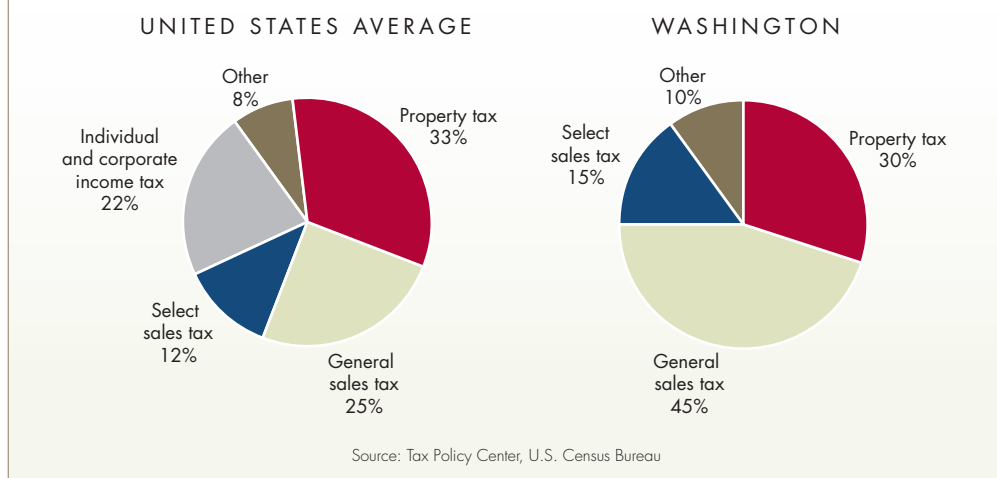
These are essential facts to any discussion of property tax reform. Because our system is so unfair, any reform should be designed in such a way to bring greater balance to the system.

### Personal exceptions to the uniformity clause

Since the 1960s, the legislature has had the authority to make exceptions to the uniformity clause for retired property owners on their principal residence. Currently there is a tax exemption program available for property owners with disposable household incomes of \$35,000 or less and who are 61 years or older, retired due to a disability, or are veterans with a service-connected disability.<sup>6</sup>

- The value of the principal home is frozen at its value on January 1 in the first year in which they are eligible (no further back than 1995).

Figure 3C: State and local taxes, 2004

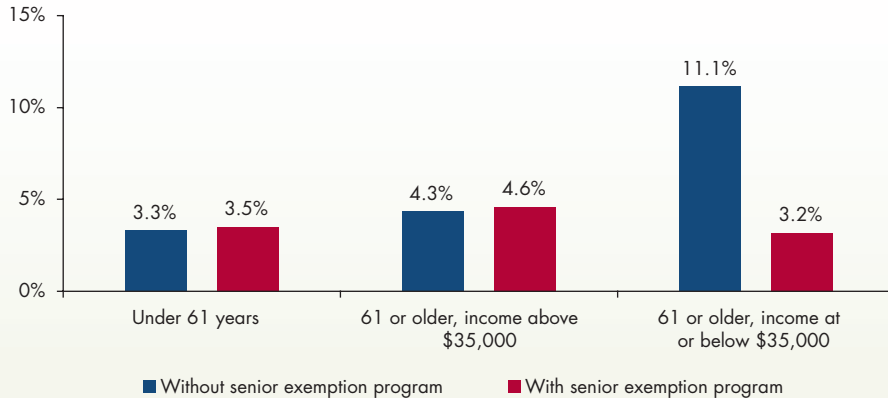


- The property owner is exempt from all special levies (including all school district levies).
- In addition, if household income is between \$30,000 and \$25,000, the greater of \$50,000 or 35 percent of the property's value is exempt from regular levies, up to \$70,000. Households with incomes under \$25,000 are eligible to exempt the greater of \$60,000 or 60 percent of the home's income from regular levies.

There is also a program in place for homeowners 60 years and older or retired from regular employment with disposable income of under \$40,000. They are able to defer all property taxes on their principal residence until death, change in use, or sale of the property. At that point, the cumulative amount owed in tax plus five percent interest becomes due. This program is not widely used: in 2005 only 1,041 people took advantage of it, compared to 115,801 in the exemption program.<sup>7</sup>

The senior exemption program does not change the amount of levy raised, but it does change how the payment of the taxes needed to raise the levy is balanced between taxpayers. A tax cut for seniors with low incomes shifts taxes to those not eligible for this program. This is demonstrated by Figure 3D.<sup>8</sup> The program raises the share of income paid in property taxes by property owners under age 61 or above \$35,000 of income. The slight tax increase on these groups is used to pay for a very substantial tax cut for lower income seniors. The program allows governments to raise the same amount of money while making the system more equitable.

Figure 3D: Share of income paid in property taxes by eligibility for senior citizen property tax exemption relief program, 2008



Source: Author's analysis of Washington State Population Survey

recent efforts at reform have been less defensible from a sound public policy perspective. Rather than target tax cuts to other groups with high property taxes relative to income, the legislature and voters have passed several broad unfocused tax cuts. These cuts have harmed the ability of local governments and school districts to provide the services residents want them to without making the system fairer.

### Property exempted from the uniformity clause

There are also a number of property types that are exempted in whole from the property tax. These include intangible personal property (such as savings accounts, stocks, and so on), business inventories, household goods, churches, nonprofit hospitals, and private colleges, among others.<sup>9</sup>

While some tax exemptions may be desirable, it is important to understand that the taxes that would otherwise be raised from exempt property are shifted to other types of property, subject to limitations on tax rates.

A particularly expensive exemption is one for motor vehicles, costing state and local governments \$1.2 billion in the 2005-07 biennium. Motor vehicles have been exempt from the property tax since 1937, but a separate excise tax was levied. In 2000, the motor vehicle excise tax was sharply curtailed.<sup>10</sup>

### How can adequacy and equity be balanced?

Over the years, property taxes have been limited in many ways in Washington State, partly in response to public criticism of property taxes as too high and unfair. These complaints are in part a matter of perception and in part an expression of frustration with the complexity and opaqueness of the system.

Of course, many property owners do have trouble paying property taxes. The legislature has recognized this in the case of seniors and people with disabilities by creating the exemptions detailed above. However,

There are other options available that would make the system more equitable and provide tax cuts to those who need them the most, all while still producing adequate funding for state and local governments. Almost every other state has implemented these types of options (see box). Two options that will be discussed here are a homestead exemption and a circuit breaker.<sup>11</sup>

### What would the effects of a homestead exemption be?

The program for seniors and people with disabilities that exempts a share of property value from taxation is Washington's only homestead exemption. It is possible to enact a homestead exemption that would extend tax reductions to other property owners who pay an unfair share of income in taxes. A number of other states have done so (see box).

A homestead exemption lowers taxes indirectly by reducing the taxable value of the property subject to the property tax. As a simplified example, a house assessed at \$200,000 that is taxed at \$10 per \$1,000 of value would pay \$2,000. If a \$50,000 homestead exemption was applied and the tax rate did not change, the owner would only pay taxes on \$150,000, or \$1,500.

Figure 3E shows how a homestead exemption of \$50,000 would affect property tax bills for property owners at different income levels. (For this model, seniors and persons with disabilities that are eligible for the existing exemption program would be able to choose the program that saves them the most money: roughly eight percent would choose the new home-

stead exemption; the rest would still do better under the old program.) While the homestead exemption would reduce the taxable value of all homes by the same amount, the primary benefit of the tax reductions will flow to those who are least able to afford property taxes. Property owners in the poorest 20 percent of households would see their property tax bill reduced by an average of 12.5 percent. The share of income spent on property taxes for this group would fall from six percent to 5.2 percent. At the other end of the income distribution, the richest twenty percent would receive, on average, a 3.1 percent tax cut and the share of income paid in property taxes would essentially remain unchanged.

In each taxing district, the homestead exemption would reduce the tax base, which means that if the state does not fund the exemption, local governments would need to raise tax rates in order to try to raise the same levies as would be raised without the homestead exemption. While the net effect for lower income property owners would be a significant tax cut, some property owners at the upper end of the income distribution would receive slight tax increases. The new tax rate would apply to all properties, so properties not subject to the homestead exemption would also see a tax increase.

If there were no limits on tax rates, the homestead exemption would be revenue neutral, meaning that the total effect on the ability of governments to fund public priorities would not change. However, in

## STATES ADDRESS EQUITY\*

### Homestead exemptions and credits

- 40 states and the District of Columbia have homestead exemptions.
- Five states, including Washington State have homestead exemptions that phase out as income rises.
- 15 states offer homestead exemptions only to seniors, persons with disabilities, veterans with disabilities, or other special populations.
- 10 other states provide more generous benefits to seniors than younger homeowners.
- No homestead exemptions directly benefit renters.

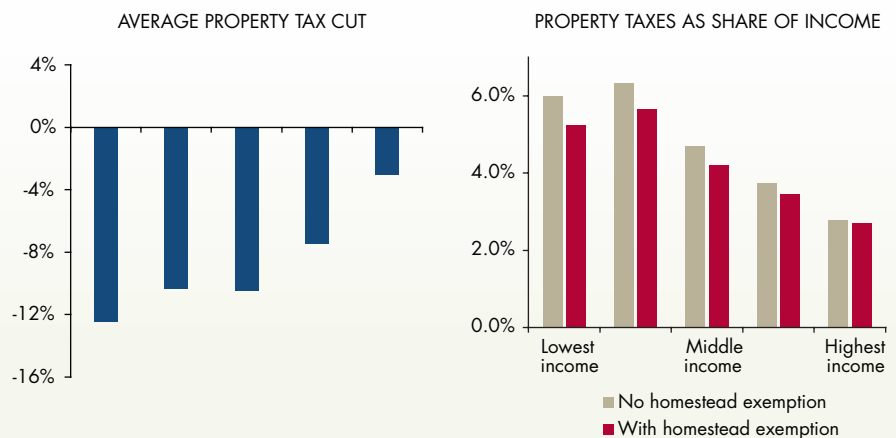
### Circuit breakers and renter credits

- 35 states and the District of Columbia have circuit breakers.
- Homestead exemptions in five of these states, including Washington State, also act as circuit breakers in that the exemption decreases as income rises.
- 25 states and the District of Columbia have circuit breakers that apply to renters as well as owners.
- Oregon has a circuit breaker that applies to renters only.
- Six states have income tax credits for renters that do not vary by income.
- 14 states have homestead credit programs.\*\*

\* Baer, David. 2003. State Programs and Practices for Reducing Residential Property Taxes. May 2003. AARP Public Policy Institute. [http://assets.aarp.org/rgcenter/econ/2003\\_04\\_taxes.pdf](http://assets.aarp.org/rgcenter/econ/2003_04_taxes.pdf).

\*\* The distinction between circuit breakers and homestead credits is that homestead credits offer the same credit to all eligible households.

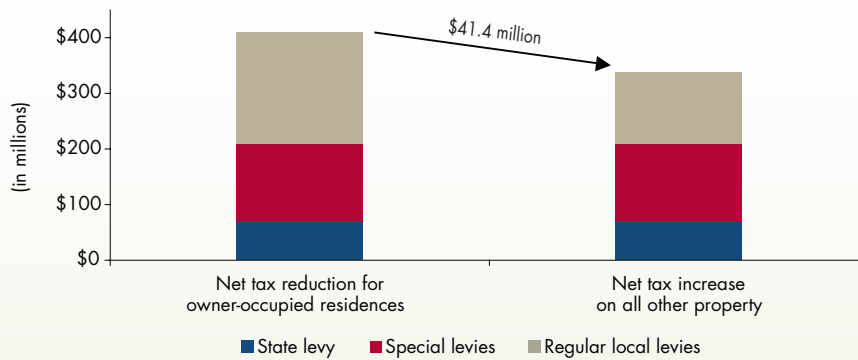
Figure 3E: Effect of \$50,000 homestead exemption on property taxes as a share of income by income fifths, 2008



Source: Author's analysis of Washington State Population Survey

Washington, a homestead exemption would interact with the rate limits. At the \$50,000 level, the state levy would be unlikely to bump up against its rate limit and local special levies would be unaffected. However, many local regular levies are at—or close to—their rate maximums. For those districts, a

Figure 3F: Tax shift and reduction for \$50,000 homestead exemption, 2008



Source: Author's analysis of Washington State Population Survey

homestead exemption would likely result in revenue loss because the up and down shifts in taxable property would combine to leave them short.

Figure 3F summarizes the revenue effect of a \$50,000 homestead exemption. The bar on the left estimates the net tax cuts at each level (state, local, and special levies) for homeowners, which total over \$400 million. The bar on the right shows the net tax increase on business and commercial property, which would equal roughly 0.1 percent of property value. The difference between the tax cuts and the tax increases would mean a revenue loss to local governments of about \$41 million. In addition, the bulk of administration would be borne by county governments, although the state could reimburse them for administrative costs.

These projections seemingly leave policymakers in a position where they have to make a decision between adequacy and equity. This need not be the case. Rate limits could be relaxed in order to hold local governments harmless from the homestead exemption or the state (which has more options for revenue restructuring) could cover the loss to local governments from another revenue source.

Making no changes to the current system is also making a choice about equity and adequacy. Under the current policies, Washington policymakers have committed to sacrificing both principles in order to limit property taxes expensively across the board.

There are many possible variations on the homestead exemption idea. It is possible to either apply the exemption to all property owners or set an income

eligibility threshold. Another choice that could be made is whether to apply the exemption to the state portion of the property tax or both the state and local portions. These various options deserve conversation and analysis in Washington State.

## What would the effects of a circuit breaker be?

A property tax “circuit breaker” has the same goals as the homestead exemption: to improve the equity of the property system by connecting taxes with ability to pay. The circuit breaker provides a tax credit to offset taxes that are high relative to household income. Just as a circuit breaker in a home protects the electrical system from an overload that exceeds its capacity, a property tax circuit breaker would protect homeowners from a property tax bill that is too high relative to their household income.

When compared to the homestead exemption, the circuit breaker can be more accurately targeted, but it would require more administrative infrastructure (although more of the administration would be done at the state level rather than the county level).

As with a homestead exemption, there are many options available when designing a circuit breaker. The main decisions that must be made include:

- At what point does the circuit “break”? Generally circuit breakers are designed so that a tax credit kicks in when a household’s property taxes are greater than a certain share of income (as set by statute).
- What should the maximum credit be? Should a dollar limit be set or should the credit be sufficient to lower property taxes until they are below the breaking point?
- Should there be an income cutoff? Only allowing the credit for lower incomes makes the program less expensive and better targeted. However, if there is a sudden point at which people are no longer eligible for the credit, it can create large increases in tax bills from one year to the next. An option to deal with this would be to gradually reduce the credit as household income rises.

- Should the credit be available to all homeowners or just the elderly, persons with disabilities, and so on?

For the purposes of comparing a circuit breaker to both the homestead exemption and the current system, this section estimates the effect of a hypothetical circuit breaker with the following characteristics:

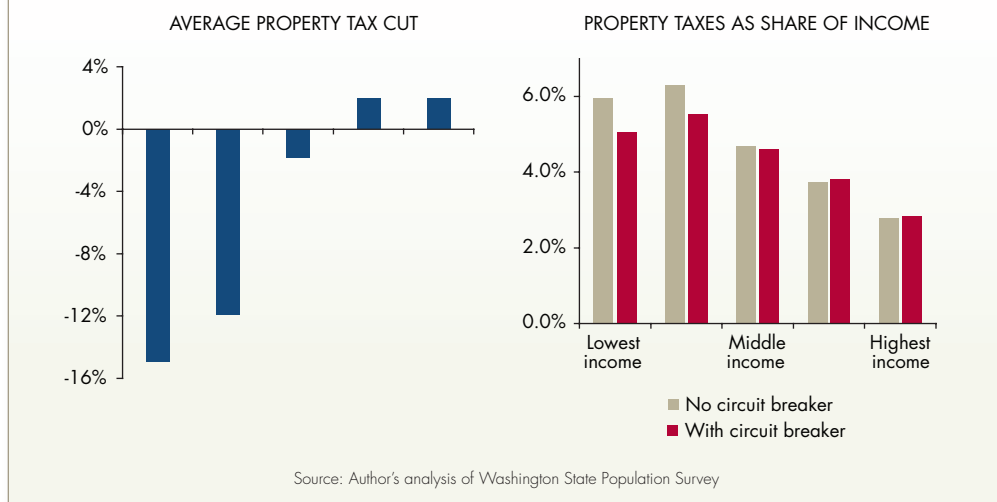
- All homeowners with incomes below \$60,000 (roughly the median income) are potentially eligible. (For the sake of simplicity, a cutoff point is used here, but a gradual reduction would be more appropriate).
- The credit becomes available when the property tax on a primary residence is above five percent of annual household income.
- The maximum credit is the lesser of: a) total state taxes paid, or b) the amount of tax needed to bring the property bill to 5 percent of income, or c) \$1,000.
- In order for the proposal to be revenue neutral, the state tax rate would be raised by \$0.18 per \$1,000 of value.

Figure G shows the effects of this circuit breaker on tax bills at different points in the income distribution. Property owners in the bottom 20 percent by income would receive an average tax cut of nearly 15 percent. Middle income homeowners would receive a tax cut of 1.9 percent and the richest homeowners would experience tax increases of 2.0 percent.

Compared to the homestead exemption modeled above, this circuit breaker proposal entails a much smaller shift in taxes to non-residential property (Figure 3H). Because the circuit breaker is a credit against the state property tax, which is well below its statutory maximum, the proposal would have no effect on local governments and would have a revenue neutral effect on the state levy.

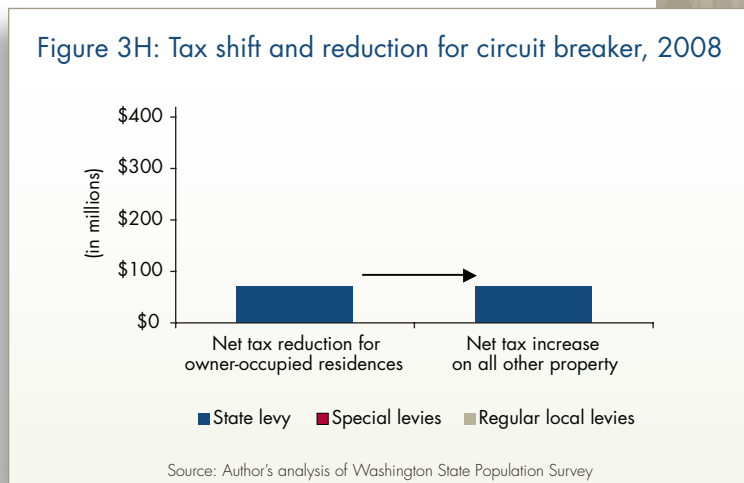
Despite being less expensive than the homestead exemption modeled above, the circuit breaker would still provide substantial tax cuts for those who need them most. (A less expensive homestead exemption

Figure 3G: Effect of circuit breaker on property taxes as a share of income by income fifths, 2008



Source: Author's analysis of Washington State Population Survey

Figure 3H: Tax shift and reduction for circuit breaker, 2008

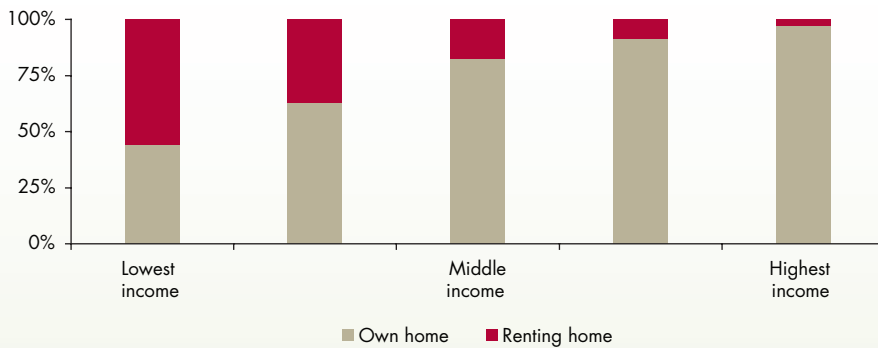


Source: Author's analysis of Washington State Population Survey

is certainly possible, but it would produce smaller tax cuts and a smaller effect on distribution.)

There is a key disadvantage of creating a circuit breaker in Washington. Its benefits would only be available to homeowners who are aware of, and apply for, the credit. If a state income tax existed, application for the circuit breaker could be part of filing an income tax return. Given that annual returns are not part of the tax system in Washington State, in order to take advantage of the circuit breaker homeowners would have to fill out a separate application providing the necessary information about income and property taxes. For that reason, an outreach program, including assistance completing the form, would be a necessary part of a circuit breaker if it is to be effective in improving the equity of the system.

Figure 31: Owners and renters by income fifths, 2008



Source: Author's analysis of Washington State Population Survey

is that renters pay half of the property taxes on their share of the property they live in.

Not surprisingly, lower income households are considerably more likely to rent than higher income households. Fifty-six percent of the poorest 20 percent of households rent (Figure 3X). Ownership grows as income rises. At the highest income quintile, 97 percent of households own their home.

## How does the property tax affect renters?

Property tax reform efforts often focus on property owners, but economists recognize that renters are also affected by property tax. The owners of rental properties pass on some portion of their property tax to renters in the form of rent increases. Their ability to do so depends on a number of factors, especially the supply and demand in the local rental market, but a common assumption made by statisticians modeling tax incidence

For these reasons, thoughtful property tax reform built around equity should include renters in the equation. Some states address this by providing a deduction on state income taxes for a percentage of rental payments. While this is not an option in Washington, an application system similar to the one mentioned above for a circuit breaker could be used to provide renters under a certain income threshold with tax rebates.

## Endnotes

1. See Washington State Constitution at <http://www.leg.wa.gov/LawsAndAgencyRules/constitution.htm>.
2. See Washington State Tax Structure Study Committee. Tax Alternatives for Washington State: A Report to the Legislature. [http://dor.wa.gov/content/statistics/WAtaxstudy/Final\\_Report.htm](http://dor.wa.gov/content/statistics/WAtaxstudy/Final_Report.htm)
3. See Washington State Tax Structure Study Committee. Tax Alternatives for Washington State: A Report to the Legislature. [http://dor.wa.gov/content/statistics/WAtaxstudy/Final\\_Report.htm](http://dor.wa.gov/content/statistics/WAtaxstudy/Final_Report.htm)
4. See [http://www.census.gov/govs/www/class\\_ch7\\_tax.html#t28](http://www.census.gov/govs/www/class_ch7_tax.html#t28).
5. McIntyre, Robert et al. 2002. Who Pays? A Distributional Analysis of the Tax Systems in All 50 States 2nd Edition. The Institute on Taxation and Economic Policy. <http://itepnet.org/whopays.htm>
6. See Revised Code of Washington 84.36.381.
7. Senate Ways and Means Committee. 2007. A Legislative Guide to Washington State Property Taxes. <http://www.leg.wa.gov/documents/Senate/SCS/WM/SwmWebsite/Publications/2007/PropTaxGuide2007.pdf>
8. For data availability reasons, this graph only includes the senior portion and does not include those with disabilities.
9. See Revised Code of Washington 84.36.
10. Initiative 695, passed in 1999, replaced the MVET with an annual thirty dollar flat fee. I-695 was declared unconstitutional, but the legislature effectively passed the same repeal.
11. These options may require a constitutional waiver of the uniformity clause.



# Conclusion

In the coming years, the legislature and voting public will make decisions impacting the adequacy and equity of the property tax system. These decisions will dictate whether key public priorities like our educational system will have the money they need to operate. This will also determine who will pay for those public structures.

The current system reflects recent decisions that have run counter to the principles of adequacy and equity. Doing nothing is tantamount to ratifying the results of those decisions: strapped local governments, inadequately funded public education, and a tax system that requires significantly more of lower income households than wealthier households.

The opportunity exists to make significant changes. These are not radical changes and have in fact been successfully adopted by dozens of other states. Reform should simultaneously address both adequacy and equity:

- Relax arbitrary tax limitations in order to allow revenue to grow along with the cost of providing valuable services.
- Adopt an equalizing policy such as a homestead exemption or circuit breaker in order to dampen the current lack of balance in the distribution of tax responsibility.

The combination of these policies would inject needed reform to the property tax system and help address the problems of inadequacy and inequity in our tax system as a whole.



# Methodology

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Original data in Chapter 3 of this report are based on analysis of the Washington State Population Survey (SPS), a biennial survey of households in the state managed by the Office of Financial Management. The data used here come from the survey conducted in spring 2006. Respondents are asked for information on demographics, income, and (importantly for this report) market and assessed value of their homes. More information on the SPS is available at <http://www.ofm.wa.gov/sps/2006>.

The methodology for imputing assessed value for respondents that do not report their assessed values as well as projections of tax rates, incomes, and property values to 2008 were developed by Rick Petersen, Tanya Carter, and Mark Matteson at the Office of Program Research, Washington House of Representatives. The modeling of the homestead exemption and circuit breaker were developed by the author using their work as a starting point.

Quintiles are determined based on the incomes of both property owners and renters. Data on the share of income paid in taxes, for example, by homeowners in the bottom quintile include only the homeowners within that quintile.

More detailed information on methodology is available from the author.

## About the author

Jeff Chapman has been the Research Director at the Washington State Budget & Policy Center since 2006. His expertise is the application of economic research to analysis of public policy. Previously, Jeff was an economist with the Economic Policy Institute (EPI) in Washington, D.C., working specifically through the Economic Analysis and Research Network (EARN). In this role, Jeff analyzed state and national economic trends and policies and provided technical assistance on statistical and economic research to national, state, and regional think tanks and advocacy organizations across the country. Jeff's work on the low-wage labor market has been widely cited in print and broadcast media and published in places including the *Monthly Labor Review*. He also contributed chapters to the recent books *The State of Working America* and *Poverty & Race in America: The Emerging Agendas*. Jeff has a BS from Oregon State University and a Master in Public Policy from Harvard University's Kennedy School of Government.

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