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Balancing Adequacy and Equity with a Property Tax Circuit Breaker

by Jeff Chapman

Property tax reform is up for debate during the current legislative session. A recent report by the Washington State Budget & Policy Center (*Balancing Adequacy and Equity in Washington State's Property Tax*, available at www.budgetandpolicy.org) discusses the state and local property tax system in detail.[1] Among the findings of this comprehensive analysis is that a property tax circuit breaker (a policy idea not currently under consideration by the legislature) has the potential to balance the needs of adequacy and equity.

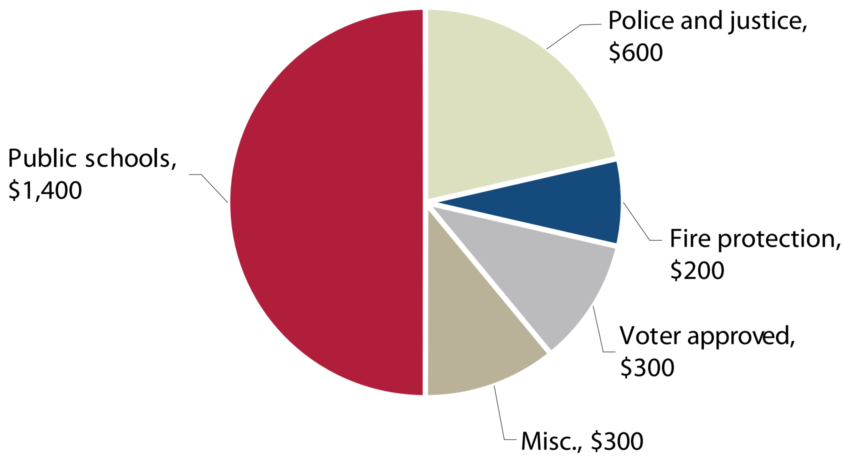
Just as a circuit breaker in a home protects the electrical system from an overload, a property tax circuit breaker would protect homeowners from a property tax bill that is too high relative to their household income. With such a policy, tax credits would partially offset taxes for homeowners with large tax bills relative to income. Many states—including Washington State to a limited degree—use circuit breaker programs to address tax inequity.

Using data from the State Population Survey, we find that a circuit breaker in Washington State would:

- Reduce property taxes by nearly 15 percent among the lowest income homeowners.
- Extend property tax reductions to renters.
- Have no impact on the ability of local governments or local school districts to provide the services Washingtonians demand.
- Require only a very modest state property tax increase in order to keep from losing state property tax revenue (all of which flows to school districts).
- Create a visible and transparent response to the needs of residents for a fairer tax system that doesn't require more than they can afford to pay.

The proposals currently under consideration do not balance the need to fund first-class education and other local services with ensuring that property taxes do not become a barrier to homeownership for lower and moderate income households. Policymakers seem poised to continue on the path of curtailing the potential of local governments and school districts while not addressing the fact that lower income homeowners pay a much larger share of their income in property taxes (six percent) than higher income homeowners (2.8 percent).

Figure 1: Property tax bill for $200,000 home, Spokane



Source: WSBP&C analysis of data from Spokane County Assessor, City of Spokane, Department of Revenue

What do property taxes pay for?

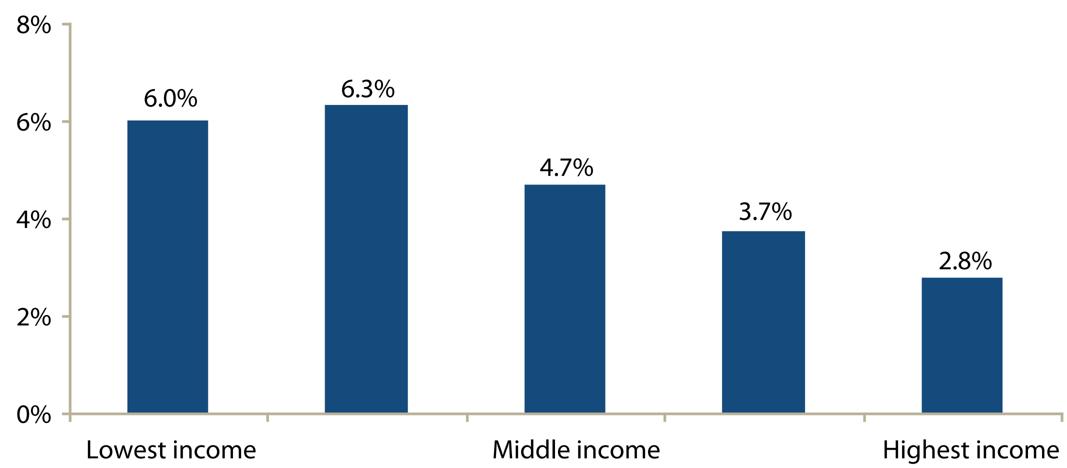
As an example, the owner of a typical home in Spokane (worth about $200,000) would receive a property tax bill for roughly $2,800 annually. Figure 1 shows how this payment would be distributed between public priorities:

- $1,400 would go to public schools (over 2/3 of this money was directly approved by 60 percent or more of Spokane voters).
- $800 would pay for police and fire protection and the justice system.
- $300 would pay for special projects (mostly transportation improvements) that were approved by at least 60 percent of voters.
- $300 for all other county and city government needs.

Why is the property tax system unbalanced?

The property tax bill described in Figure 1 would require less than three percent of the income of a household earning $100,000, but over nine percent of income for a household earning $30,000. Statewide, estimates from the State Population Survey suggest that homeowners in the richest one-fifth of Washingtonians pay, on average, less than three percent of their income in property taxes while homeowners in the bottom 40 percent pay about six percent of their income in property taxes (Figure 2).

Figure 2: Share of income paid in property tax by income fifths, 2008



Source: WSBP&C analysis of Washington State Population Survey

Figure 2 only considers homeowners, but renters pay property taxes as well, albeit indirectly through increased rental payments. Lower income households are much more likely to rent than higher-income households (56 percent of the poorest fifth of households rent, compared to three percent at the top). Because of this, Figure 2 actually underestimates the extent of the system's imbalance.

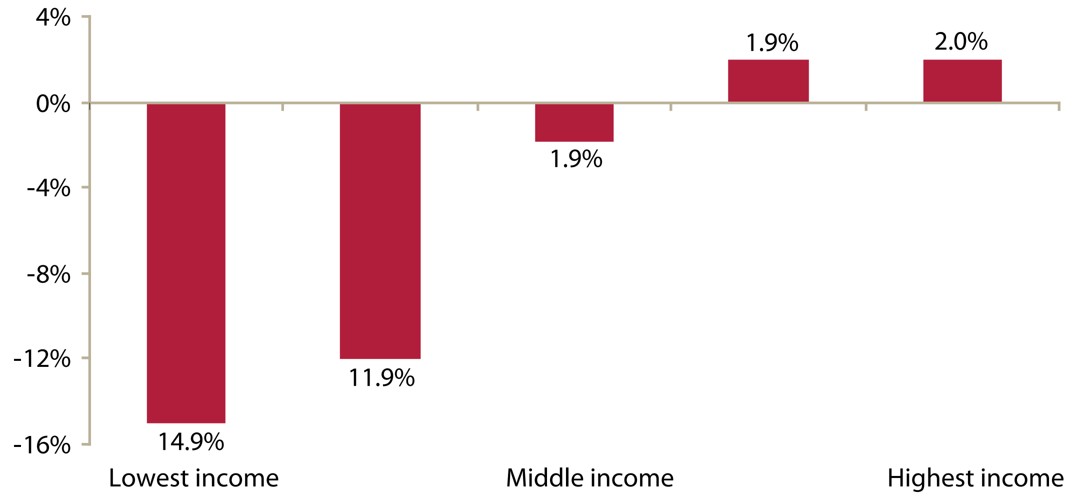
There are essentially two criteria for the size of a property tax bill: 1) where the home is located and 2) the assessed value of the home. The first criterion (location) is because of the local nature of the system: a homeowner in Yakima does not pay for fire protection in Bellingham and voters in Kennewick do not vote to raise their property taxes to pay for a new bridge in Chehalis.

The second criterion (home value) is designed to tax homeowners according to their economic wellbeing. Increased property value allows for greater wealth, income upon sale of the property, and increased access to credit. However, property value does not correlate perfectly with the ability to pay property taxes and property taxes set solely with regard to property value can become a barrier to home ownership, a fact that is borne out in the data.

How should a property tax circuit breaker be designed?

There are numerous ways to design a property tax circuit breaker, but the design of the policy should reflect its goal: to protect homeowners from unaffordable property tax bills while still allowing local governments to raise adequate revenue.

Figure 3: Average tax cut by income level under circuit breaker proposal, 2008



Source: WSBP&C analysis of Washington State Population Survey

The following are characteristics of a circuit breaker that would meet the needs of Washington State:

- The tax credit would kick in when a household's property taxes are greater than a certain share of income (five percent, for example).
- The maximum tax credit should not be capped at a level that is too low to provide meaningful tax reduction.
- The tax credit should be available to moderate as well as low-income households and should be available broadly, not just to the elderly or persons with disabilities.
- The credit should be available to renters as well as owners.

Property owners in the bottom 20 percent by income would receive an average tax cut of nearly 15 percent with a circuit breaker that met these criteria (Figure 3).[2] Middle income homeowners would receive a tax cut of 1.9 percent and the richest homeowners would experience tax increases of 2.0 percent. The system would still require a higher share of income in property taxes from lower income households than wealthier households, but the size of the imbalance would be lowered.

These estimates assume that the circuit breaker would result in a modest increase in the tax rate (roughly $0.18 per $1,000 of property value). This increase would ensure that the circuit would have no effect on local tax revenue.

The state tax revenue would also remain the same, but about $70 million in tax responsibility would be shifted from primary residences to other types of property (such as commercial property or vacation homes). This amount is equal to about two-hundredths of one percent of the value of non-primary residence property.

A circuit breaker would require spending on administration at the state level. Also, the benefits would only be available to those homeowners and renters who are aware of, and apply for, the credit. For this 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.

Property tax circuit breakers in other states

A total of 35 states (including Washington State's limited program) have programs that act like circuit breakers, (i.e. that they take household income into account when determining total property tax payments).[3] Under a more strict definition—that the program takes into account the share of income paid in property taxes—18 states have circuit breakers.

A new report by the Center on Budget and Policy Priorities details the characteristics of these 18 programs.[4] The main findings are:

- The circuit breaker is available to families and individuals regardless of age or disability status in 10 states.
- Circuit breakers are available to both homeowners and renters in 16 of the 18 states, to homeowners only in Oklahoma, and renters only in Oregon.
- Some states extend the circuit breaker only to taxpayers with very low incomes, while others extend their program to middle-income families as well.
- Nine states administer their circuit breakers through a process that is separate from their income tax system, an important point since Washington State does not have an income tax.

Current policy in Washington State

The State Constitution already recognizes the importance of a connection between property tax responsibility and the ability to pay. Over 100,000 homeowners in the state take advantage of this program, which is available to 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.

This exemption program does not change the amount of levy raised, but it does change how the payment of the taxes is balanced between taxpayers. Without this program, low-income seniors would pay an average of 11 percent of their income in property taxes rather than the three percent they pay under the program. This substantial tax cut is paid for by a slight tax increase on younger and/or wealthier households.

Conclusion

In the coming weeks, the legislature has an opportunity to shape property tax policy in a way that will ensure whether key public priorities like our educational system will have the money they need to operate. Their decisions will also determine who will pay for those public structures. Past decisions have led to strapped local governments, inadequately funded public education, and a tax system that requires significantly more of lower income households than wealthier households. A property tax circuit breaker could add balance to the system without hampering key public priorities.

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Endnotes

1. Chapman, Jeff, 2007. Balancing Adequacy and Equity in Washington State's Property Tax. Washington State Budget & Policy Center. http://www.budgetandpolicy.org/documents/propertytax.pdf.
2. The circuit breaker modeled is available to all homeowners with incomes below $60,000 and primary residence property taxes 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.
3. 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.
4. Lyons, Karen , Sarah Farkas, and Nicholas Johnson, 2007. The Property Tax Circuit Breaker: An Introduction and Survey of Current Programs. Center on Budget and Policy Priorities. http://www.cbpp.org/3-21-07sfp.htm.