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It's Elementary

A Monthly Column by EFAP Director John Yinger
August 2005

School Finance Reform and Property Values Part 1: Property Tax Capitalization

Education finance reform has many predictable ripple effects that policy makers should know about. This column and the next discuss one important type of ripple effect, namely the impact of education finance reform on property values. This ripple effect works through property taxes and school quality, both of which are altered by education finance reform. This column focuses on the impact of property tax changes on house values, which scholars call property tax capitalization. The next column focuses on the impact of school quality changes on house values.

The basic idea of property tax capitalization is straightforward: A household will pay more for a house with low property taxes than it will pay for an otherwise identical house in an identical neighborhood with high property taxes. Moreover, if the property taxes on a house are raised and nothing else changes, then the market value of that house will fall.

Scholars can be quite precise about this relationship. If the annual property taxes on a house go up by \$1,000 relative to other houses and this increase is expected to last indefinitely, then the market value of the house will go down by the value a household places on the higher stream of property taxes in the future. Using a standard type of analysis called discounting, this \$1,000 annual tax increase will be translated into a property value decline of roughly \$20,000.

Discounting translates future benefits and costs into their value today, also known as their present value. Thus, property tax capitalization is an example of the principle that the value of an asset, in this case a house, equals the present value of the net benefits from owning it, including property taxes.

The basic idea of property tax capitalization is straightforward enough, but the existence of property tax capitalization has some hard-to-understand implications for public policy. These implications arise because, in the presence of capitalization, property tax changes show up in house values immediately and **there is no way to escape** them. Homeowners who experience a property tax increase, for example, must either stay and pay the higher tax or leave and suffer a capital loss when they sell their house. Either way they pay. Similarly, homeowners who experience a property tax decrease receive a bonus whether they stay or leave.

Moreover, the loss or gain a homeowner experiences equals the **full present value** of the future increases in property taxes. In the above example, the homeowner loses \$20,000, not just the annual tax increase of \$1,000.

Capitalization also implies that people who buy houses after a property tax change has been announced are not affected by the change. To continue with our example, a property tax increase of \$1,000 for a particular house implies that anyone who buys that house in the future will pay \$20,000 less for the house than he would have before the tax change. This \$20,000 price cut from the perspective of the future buyer is, of course, the flip side of the \$20,000 capital loss to the person who owned the house at the time the tax change was announced.

Education finance reform almost inevitably involves an increase in state aid to some school districts and may involve a decrease in state aid to others. As discussed in the last column, an increase in state aid will lead to an increase in school spending, but in many cases the aid increase exceed the spending increase. In other words, school districts often take advantage of an aid increase to cut their own local property taxes.

For the purposes of this column, let us assume that an increase in aid does not affect local spending at all, but instead simply leads to an equal decrease in local property taxes. (I'll consider changes in spending in my next column.) Now suppose that state aid to a particular district increases enough so that a homeowner in that district experiences a property tax cut of \$1,000. According to the logic of property tax capitalization, a tax cut of this magnitude is equivalent to a \$20,000 capital gain for this homeowner.

Education finance reform also changes property taxes for owners of rental property. The available evidence indicates, however, that these owners are unlikely to alter rents significantly in response to these tax changes; in other words, these owners do not pass these tax changes, positive or negative, on to tenants. Thus, tenants, unlike homeowners, are largely unaffected by the property tax changes associated with education finance reform

In short, the ripple effects of education finance reform include capital gains for homeowners in districts in which state aid increases and capital losses in districts in which state aid declines. These capital gains and losses are relevant to policy makers for several reasons.

First, it may be difficult for policy makers to find support for a particular education finance reform plan among voters who expect to experience aid cuts, and hence capital losses, from that plan. This may explain why some states have selected education finance reform plans that help the lowest-performing districts without penalizing those that perform the best.

Second, the gains and losses associated with reform-induced property tax changes raise complex issues about the fair treatment of taxpayers both within and across districts. Within districts, these changes affect current homeowners but have little impact on renters or future homeowners. Across districts, these changes benefit current homeowners in districts in which aid increases but impose costs on homeowners in districts in which aid declines.

To some degree, these gains and losses may be seen as compensation for the prior education finance policies that created the need for education finance reform. After all, the values of houses in a school district are depressed when that district does not receive the state aid to which it is entitled according to the state's constitution. Reform-induced capital gains to long-term homeowners in this

district therefore seem fair. Nevertheless, many of these gains and losses cannot be justified by any fairness principle.

The benefits that education finance reform can provide to students in needy school districts are far more important than these often-arbitrary capital gains and losses for homeowners. Nevertheless, policy makers should recognize that some arbitrary capital gains and losses for homeowners are part of the cost of education finance reform.

A homeowner in another district provides this homeowner with could this tax cut would In this case, homeowners

y the full amount boost educational performance and spending

In theory the gains and losses are imposed at the instant a policy change is announced, but in practice there may be some time before information is complete or before people really believe that the change will be implemented. This issue is relevant for public policy because owners may be able to escape some, or even most, of the impact of property tax changes if (a) there is a lag between announcement and implementation and (b) they act right after announcement.

Now consider **assessment reform**. In many jurisdictions, assessments are badly out of date and some houses have much higher assessments than others relative to their true market values. Assessment reform brings all houses to the same assessment/sales ratio and therefore raises taxes for houses that were under-assessed relative to houses that were over-assessed. Consequently, assessment reform leads to capital gains for some (owners of houses that were over-assessed relative to other houses) and to capital losses for others (owners of houses that were under-assessed).

For long-term residents, these changes are fair. A resident who has been under-assessed for a long time has been given, in effect, a loan from the city and revaluation just claims back this loan. But for new residents, these changes are not fair. If someone bought an under-assessed one day and assessment reform is announced the next, this person has a huge capital loss even though she did not benefit at all from the poor assessment system. In fact, capitalization implies that this person paid a premium for her house right before being socked with a huge tax increase.

One way to minimize this fairness problem if it arises is to institute a long lag between announcement and implementation. As explained earlier, this lag may allow owners at the time of announcement to escape some of the burden of the tax changes.

Better yet, this fairness problem does not arise if assessments are kept up to date, or even if houses are always revalued upon sale, which has not typically been the policy in New York and a few other states.

So a revaluation imposes some unfair gains and losses in order to restore faith in the property tax and local government and to ensure fairness in the future. This trade only makes sense if assessments are updated regularly thereafter. Otherwise, small gains and losses are handed out each year as assessment errors mount, which is unfair and undermines the case for reform.

In addition, poor assessments lead to court cases, which the city usually loses. Someone can buy a property cheap because its property taxes are relatively high and then sue the city to get a rebate because of unfairly high taxes. This happened in Boston, to the tune of tens of millions of dollars. The only way to avoid this crazy situation is to keep assessments up to date!

In the case of Proposition 13, assessment growth is fixed at 2%, so the assessment/sales ratio, and hence t , declines over time for long-term owners. This cannot be turned into a capital gain because houses are revalued upon sale. But it still represents a gift to owners who stay (and discourages mobility). The U.S. Supreme Court said this was legal, and California voters like the reward to long-term residents. I do not think it is fair.

Another application is to state aid. If a jurisdiction gets aid and cuts its property taxes (we will ignore service impacts for now), this leads to a capital gain to residents. Because aid is sometimes based on property values, there is a strange **feedback** here: low property values lead to more aid which leads to higher property values which leads to less aid.

As several scholars have pointed out (including Bob Inman long ago and Caroline Hoxby recently), this leads to problems with GTB aid (a form of matching aid discussed in an earlier class). The property value effects undermine the objectives of the aid program. As I show in a draft (with simulations that may be performed by an economics student), this does not happen in any important way with foundation aid.