

# Impacts of Property Tax Reform

**In March 2008, a major property tax relief and reform effort became law in Indiana. As a result of that law . . .**

**residents are expected to experience significantly lower property tax rates.**

- \$840 million in homestead credits will be distributed to taxpayers through 2010 to provide temporary relief.
- Homestead owners will receive larger tax deductions.
- Property tax rate caps will be applied with lower rate ceilings on homesteads and other residential properties.
- Some property tax-related costs (levies) are transferred to the state.

**some positive indirect effects may occur.**

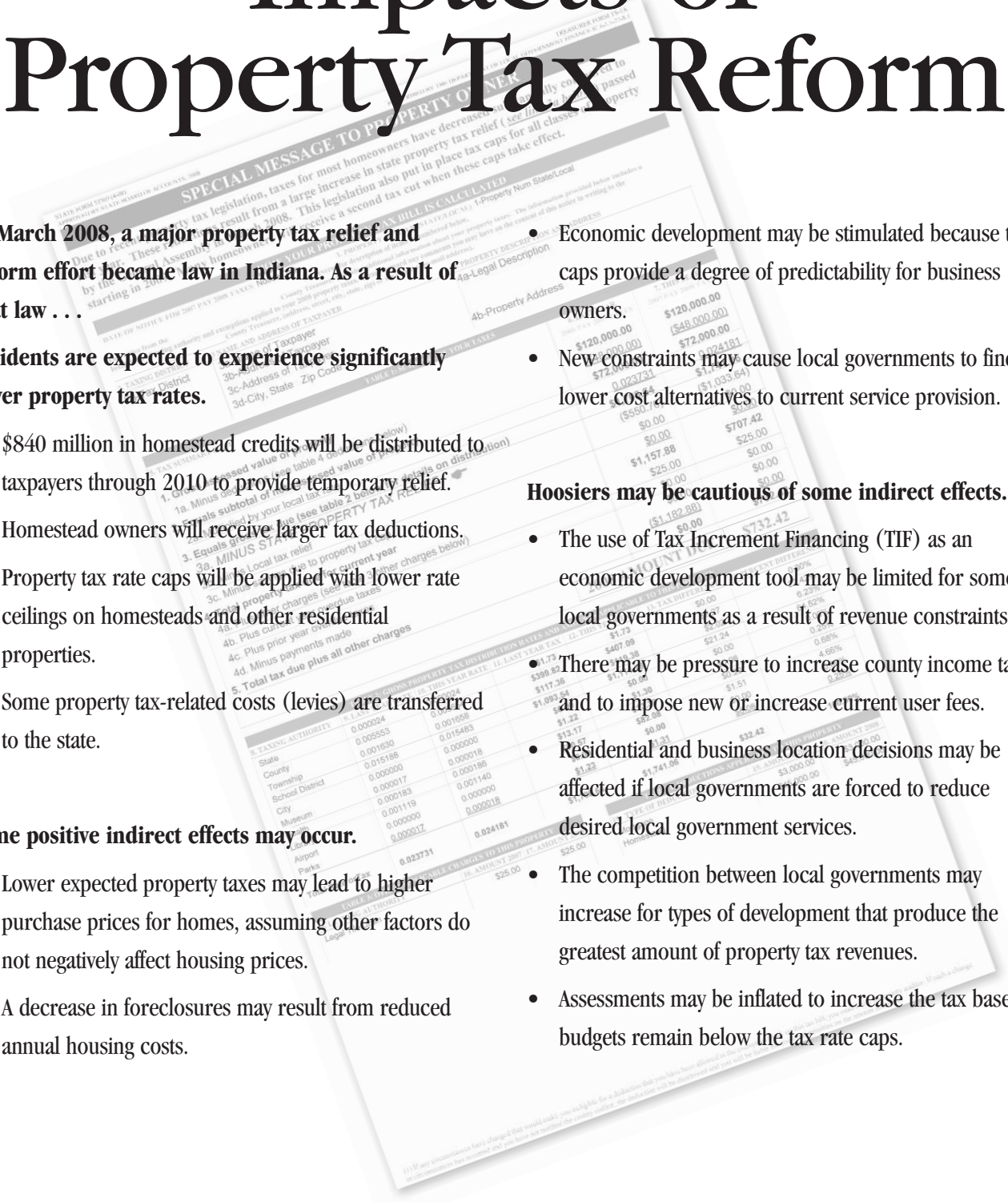
- Lower expected property taxes may lead to higher purchase prices for homes, assuming other factors do not negatively affect housing prices.
- A decrease in foreclosures may result from reduced annual housing costs.

• Economic development may be stimulated because tax caps provide a degree of predictability for business owners.

• New constraints may cause local governments to find lower cost alternatives to current service provision.

**Hoosiers may be cautious of some indirect effects.**

- The use of Tax Increment Financing (TIF) as an economic development tool may be limited for some local governments as a result of revenue constraints.
- There may be pressure to increase county income taxes and to impose new or increase current user fees.
- Residential and business location decisions may be affected if local governments are forced to reduce desired local government services.
- The competition between local governments may increase for types of development that produce the greatest amount of property tax revenues.
- Assessments may be inflated to increase the tax base so budgets remain below the tax rate caps.





## Home prices may increase

The reduction of property taxes for owner-occupied housing can be expected to result in a related increase in the value of single-family homes, assuming supply and demand and the quality of local government services remain constant.

Purchasers of a home have an amount they are willing and able to pay each month or year to live in any house they are considering. That amount will include the payment on the mortgage secured to finance the property, the property taxes they will be required to pay, and other costs such as insurance which can be ignored here because they will not change. A decrease in the property taxes then results in a concomitant increase in the amount of the mortgage payment buyers are willing and able to pay, thus increasing the price they are willing to pay for the home.

The technical name for this is the capitalization of property taxes in housing prices. Property taxes represent an ongoing, regular stream of payments that the purchaser of a property is obligated to pay. Capitalization represents the translation of this stream of property tax payments into its present value. This value represents the reduction of the price that the purchaser is otherwise willing to pay for the property.

A reduction in property taxes can likewise be capitalized to obtain its present value. This present value of the reduction in property taxes would then represent the increase in price that might be expected to result from the reduction in the taxes.

Numerous studies have shown that property taxes are in fact capitalized into the sales prices of homes. Some of these studies have examined differences in property taxes across similar properties within taxing jurisdictions where the tax payments varied due to under- or over-assessment. Others have examined differences in taxes between nearby jurisdictions having different property tax rates. The studies have found that the property tax differences are reflected in differences in sales prices.

## RELEVANT COMPONENTS OF HOUSE ENROLLED ACT (HEA) 1001

### Property Tax Changes

- Temporary Homestead Credits 2008 -2010 and Permanent Homestead Deductions
  - Temporary homestead credits will be distributed to homestead owners in 2008 (additional \$620 million), 2009 (\$140 million), and 2010 (\$80 million).
  - Timeline is set to abolish Homestead and Property Tax Replacement Credits to pay for additional costs assumed by the state as a result of HEA 1001.
    - Homestead Credits abolished after 2010
    - Property Tax Replacement Credits abolished in 2009
  - Standard homestead deductions are permanently set at \$45,000 and the deduction cap is increased from 50 percent of assessed value to 60 percent of assessed value.
  - A supplemental homestead deduction was established. The supplemental deduction is applied to the assessed value after the standard deduction.
    - 35 percent up to \$600,000 assessed value
    - 25 percent over \$600,000 assessed value
  - An additional property tax credit is available for certain homestead owners (based on income) aged 65 years or older to maintain annual property tax increases below two percent.
- Some Local Property Tax Levies abolished and costs assumed by state
  - School corporation tuition support
  - Special education and preschool
  - County welfare
  - Hospitals
  - Juvenile incarceration
  - Police and firefighter pension (pre-1977) payments
  - State forestry, state fair, and DLGF database management
  - Circuit Breaker Property Tax Credit—phased in caps (by 2010) on percentage of gross assessed value for which a taxpayer may be liable.
  - Homestead liability cap: 1.5 percent 2009; 1 percent after 2009
  - Non-homestead residential, agriculture, and long-term care property liability cap: 2.5 percent 2009; 2 percent after 2009
  - Non-residential and personal property: 3.5 percent 2009; 3 percent after 2009

### Other Key Changes

- State sales and use tax increase from 6 percent to 7 percent. The 1 percent sales and use tax increase, gaming revenue, and funds originally committed to Property Tax Replacement Credits and Homestead Credit will pay for assumed state costs under act.
- State Tuition Reserve Fund established for potential future revenue shortfalls in school general fund.
- Increased income deductions for renters (from \$2,500 to 3,000) and increased Indiana Earned Income Tax Credit
- Strict limits on local government spending for capital projects, including school building projects and Council oversight of non-elected board budgets.



Determining the present value of a reduction in property taxes requires making assumptions regarding the number of years to be considered and the interest rate. Since 30 years is the most common term for mortgages, it is the logical period to be considered. Mortgage interest rates vary, of course. The higher the assumed mortgage interest rate, the lower will be the capitalized present value of the reduction in property taxes.

To provide an example of this effect, assume a mortgage interest rate of 6 percent for a 30-year mortgage. (In recent years, rates have been both below and above this amount.) Then consider a reduction in annual property taxes of \$1,000. Many homeowners in Indiana will see reductions approaching this amount or more. The capitalized present value of the property tax reduction would then be \$13,764. This would represent a significant increase in the value of most homes in Indiana.

House prices rise (and sometimes fall) for a variety of reasons, as everyone now is too well aware. The reduction in property taxes is just one factor that will affect future house prices. So it is impossible to say how much house prices will rise (or fall). But it is reasonable to assume that they will be higher than they otherwise would have been as a result of the property tax reduction.

One side note on this effect: Some have pointed out that the reduction of property taxes will result in the payment of higher federal income taxes because of the reduced deduction. For those purchasing homes after the increase in prices resulting from the property tax reduction, the increased prices will result in higher mortgage interest payments. The ability to deduct the additional interest should just offset the reduction in the deduction of property taxes. So in the long run, considering the effects on those purchasing houses from this point forward, the property tax reduction does not result in greater payments of federal income taxes.

For those who own their home now and do not move, the reduction in the property tax will result in a decreased

deduction and an increase in their federal income taxes. Their mortgage interest payments and that deduction will not increase. But they are benefiting from the increase in the value of their home, which they can expect to realize when they choose to sell, and they will have increased borrowing power as a result of increased equity in their current home.

### **Foreclosure problem may be eased**

Only a relatively small portion of the homeowners who would be facing foreclosure will find the reduction in property taxes and the increase in home prices enough to make a difference. For many, their problems are too great. But those who are almost able to avoid foreclosure could find the property tax reduction or the increase in house prices just enough to allow them to avoid foreclosure. The increase in property values would help those at risk of foreclosure by increasing access to credit (home equity) or perhaps enabling a financially troubled homeowner to sell the home for more than they owe.

The reduction in property taxes has the direct effect of lowering the amount that a distressed homeowner will need to pay. But there is a problem here. Most of these homeowners pay their property taxes through payments into escrow accounts held by the lender, with the amounts of those payments set based upon the (higher) property tax payments in the preceding year. Under normal circumstances, a homeowner paying taxes through an escrow account would only see the benefit of a property tax reduction months later, when the amount to be paid for taxes into escrow is then reduced because of the lower taxes now expected for the next year, and a refund is provided for the surplus from overpaying during the previous year. The procedures for the lenders setting amounts to be escrowed are governed by federal law.

For some homeowners on the verge of foreclosure, this delay in seeing the benefits of the property tax reduction could mean the difference between keeping their house and losing it. The state of Indiana might work with lenders (most of whom will be



national) to help them understand the nature and magnitude of the property tax reductions in Indiana and to encourage the lenders to return these amounts back to troubled homeowners more quickly or apply these amounts to overdue payments to help them avoid foreclosure.

The increases in home prices resulting from the property tax reductions might have some positive effect on the foreclosure problem, but again there are some issues that may limit the benefit. First, the expected increase in home prices is not likely to come immediately or all at once. It will take some time for the market to reflect these changes. That delay works against the homeowner facing foreclosure. But if any increases are reflected in the market in time, that may provide some homeowners with the opportunity to sell their houses at somewhat higher prices and avoid foreclosure in that way.

Second, increased housing values may also affect lender behavior. For lenders, the decision to foreclose is affected in part by house prices since the house represents the collateral on their loan. A lender seeing falling prices is likely to foreclose more quickly to cut the losses, while increasing prices allow for more patience and forbearance. Again, this represents an area in which provision of information to the lenders may be a helpful policy. If lenders can understand that the property tax reductions can be expected to have a positive effect on house prices, that may increase their willingness to work out arrangements with borrowers to avoid foreclosure, at least in some situations.

### **Tax rate caps may help economic development**

Understanding what factors are most important in attracting new economic development is difficult, making assessing possible effects of the property tax reform more speculative. That said, we suggest that a property tax cap would provide a degree of certainty to commercial and industrial firms, and this could be a powerful factor in aiding state and local economic development efforts. The fact that property taxes for commercial

and industrial properties will be capped at three percent (rather than the one percent for owner-occupied residential properties) may on the surface appear to have a negative impact, as evidenced by comments from the Indiana Manufacturers Association and the Indiana Chamber of Commerce. However, many experts suggest that firms especially dislike uncertainty. From this perspective, the three percent cap on property taxes limits future tax increases for commercial and industrial property and may be a positive factor in efforts to attract new economic development.

### **Local governments may find lower cost alternatives and prioritize more effectively**

Property tax reform will result in a reduction in property tax revenues for some units of local government. Faced with lower revenues, some local governments may work to find lower cost alternatives to current service provision to make up for the shortfall. The ability of local governments to offset tax revenue reductions through efficiency gains will depend, of course, on how efficient or inefficient local government operations have been in the past. Units of local government that have been running very efficient operations will have less opportunities to offset revenue reductions by further increasing efficiency.

All governmental units constantly face competing demands from citizens for the provision of new services and for increases in the levels of existing services. And all governments have to make choices from among those demands. With constraints on revenues resulting from the property tax reform, local governments will need to devote more attention to setting their priorities when choosing which services to fund. This becomes even more complex when governmental units overlap one another and must compete for limited funds to meet their own priorities.

### **Tax increment financing may become more difficult**

Many units of local government have made active use of tax increment financing (TIF) to generate the critical investment in infrastructure and other improvements that are essential to





attract new economic development, such as the Honda and Toyota facilities. If the new property tax structure reduces the amount of property tax revenue generated by commercial and industrial properties, it will also reduce the amount of TIF revenue available to local governments. A reduction in local TIF revenue will mean either that local communities will have less revenue available to invest in the improvements necessary to attract new industries or will need to find a new source of revenue for capital investment.

The use of TIF is not without controversy. The creation of a TIF district directs the tax revenue attributable to new assessed value within a specified area toward the redevelopment district. Proponents of TIF argue that but for the TIF, investments leading to the new assessed value would not occur. However, in some communities, school districts and other taxing units have objected to the use of TIF, arguing that it directs revenue away from their unit. In a more constrained revenue environment created by the property tax reform, it would not be surprising that such contention over the use of TIF might increase.

### **Other taxes and fees may rise**

As the property tax reform was being considered, numbers of participants in the process observed that the limitations on property taxes could cause increased use of county income taxes, resulting in either the imposition of such taxes where they did not exist or raising of the rates for existing taxes.

Beyond the income tax, it is reasonable to expect that local governments may seek to generate additional revenue by imposing or raising various user fees for local government services. New fees to use parks or swimming pools would be one example. Existing fees, such as fees for various permits issued by local governments, might be raised. (By law, many of these fees are limited to the costs to local government of providing the service, but one might expect efforts to maximize the accounting of those costs to maximize the allowable fees.) Other states that have imposed property tax limitations have

seen major increases in local government user fees.

### **Some local government services may be reduced**

Faced with reduced revenues, some units of local government may decide they have no choice but to reduce or eliminate some of the services they provide. The consequences of such reductions will depend, of course, on which services are affected and how deep the cuts are. Assuming that the services cut were valued by at least some in the community, cuts in any service would have the effect of reducing the overall quality of life in the community. If cuts need to be made to services involving the protection of public health and safety, consequences will be more severe and might be expected to have more significant economic impacts. For example, cuts in public health efforts that result in increased incidence of disease will increase health care costs, and cuts in fire protection may result in increased losses and most likely will result in increased insurance premiums for residences and businesses in the community.

Most economic development experts agree the overall quality of life in a region as well as the best intersection of public services and costs are important considerations for firms seeking to locate or expand. In the long run, and perhaps even in the shorter term, if limits on local government revenues result in service provision decline or if firms have concerns about the future ability of local governments to provide adequate levels of service, this may raise questions for them and negatively impact state and local economic development efforts.

### **More competition for revenue-generating development**

Local governments have long competed for commercial and industrial development, both to generate jobs and to increase property tax revenues, since such development generates more revenue than it costs in services. With the property tax reform, the competition for such development is likely to escalate and become fiercer. Communities facing capped property tax rates and seeking additional revenue will want to attract new development that pays property taxes at the highest, three



percent, capped rate, as opposed to the lower one and two percent rates for residential development.

Such competition may be expressed in a variety of ways. Governments may zone more land for commercial and industrial uses to maximize the opportunities for such development. They may be much more willing to grant rezonings and relax development standards to accommodate developers seeking to locate in their communities. While negatively affecting the short-term tax revenue, property tax abatements may be more regularly proffered to new locators to maximize the chances of their choosing to develop in a community.

Firms seeking sites for new development will respond to this increased competition by using their increased leverage to pit communities against one another to extract the best terms for development.

This cutthroat competition has developed in other states that have imposed property tax limitations. The form has depended on the nature of the tax limits and the possibilities for local governments generating additional revenue. In California, for example, after passage of the Proposition 13 limitations, possibilities for generating additional property tax revenue were sharply limited. But cities in California automatically receive a share of the sales tax revenues generated within their boundaries. As a result, California cities have engaged in extreme competition to attract retail development that would increase sales tax revenues.

If local income taxes are increasingly relied upon to pay for public services previously funded by property tax revenues, local communities are likely to increase their efforts to attract and retain high income residents. The communities may choose to use property tax abatements and other traditional economic development incentives to attract high income households to their community. Exclusionary zoning and other land use

behaviors that provide homeowners with confidence in their current and future property values may also be tried. To the extent that this competition results in better schools and better services at lower costs, the competition will be good for taxpayers – the risk is that those with lower incomes will be excluded from many communities and school districts.

### **Assessments may increase**

Under the old property tax system, overall assessment levels did not affect the property tax revenues collected by local governments. The amount of taxes to be raised was divided by the total assessed value of property to determine the tax rate, so higher assessments would have meant lower tax rates and vice versa.

Under the old system, an assessor (who we are assuming was trying to assess property fairly) had an incentive to assess property on the low side. Lower assessments would make property owners happier (thinking they got a good deal). Lower assessments would also tend to reduce the number of appeals by property owners whose property had been assessed somewhat higher than it perhaps should have been.

Property tax reform changes the assessment environment dramatically. When jurisdictions are at the capped level for any class of property (the one-percent cap on owner-occupied, the two-percent cap on other residential, and the three-percent cap on most nonresidential properties), property tax revenues for properties in that class cannot be increased by increasing the property tax rates. The only way tax revenues can go up is if the total assessed value of properties increase.

In jurisdictions with tax rates at the capped levels that see needs for additional revenues, assessors may come under pressure to increase assessments in order to generate more tax revenue. Assessors will, of course, be constrained by the legal requirements for assessment. But it would not be surprising that they do everything they can to maximize assessments.



In times of rising property values, the pressure will then be to reassess property as quickly as possible to capture the increased tax revenues that such increased values could yield. Conversely, if property values fall, the incentive would be to delay reassessment to delay the drop in tax revenues.

A desire to maximize tax revenues by maximizing assessed values may also cause assessors to become more aggressive in defending their assessments when appeals are made. Very large, high-value properties are difficult to assess, and appeals by the owners are common. Owners often devote considerable resources toward pressing their claims for reduction in assessments, as even relatively small percentage reductions in assessments can mean very large absolute reductions in the property taxes paid.

Under the old system, only limited incentive existed for assessors to devote major resources to defending against such appeals. Reduced assessments could mean reduced revenues in the first year of the assessments when tax rates had already been set. But in subsequent years before another reassessment, reductions from appeals would only redistribute the tax burden.

Under the new system, with caps in effect, assessors may want to defend more strongly against appeals to reduce assessments because of the effect on revenues. And local governments may realize that it is worth their while to devote more resources to the assessors' offices to enable the assessors to do so most effectively.



## Indiana's Future: Identifying Choices and Supporting Action to Improve Communities

This project, funded by an award of general support from Lilly Endowment, Inc., builds on the Center's research to increase understanding of Indiana. The Center's faculty and staff work to identify choices that can be made by households governments, businesses, and nonprofit organizations to improve our quality of life. Our goal is to understand the people, economics, problems, and opportunities in Indiana, and to help decision-makers understand the impact of policy decisions. The Center also works to mobilize energy to accomplish these goals.

HEA 1001, passed by the Indiana General Assembly in 2008, is intended to provide property tax relief to Hoosiers. This issue brief examines the direct and indirect effects of the reform effort on house prices, community quality of life, and local government services.

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State of Indiana

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