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Ideas in Action

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When Good Policies Go Bad:

Unintended Economic Consequences of Assessment Caps

by Todd D. Jones

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The 1992 Save Our Homes amendment to the Florida constitution was intended to prevent local governments from taxing people out of their homes by limiting annual assessment increases to three-percent or CPI, whichever is lower: a noble public policy that has accomplished its goal. In hindsight, however, most Floridians today acknowledge that the Save Our Homes amendment has resulted in sometimes dramatically disproportionate tax burdens among home owners: clearly, an unintended consequence of what has come to be regarded as a flawed policy.

In 2008, the voters expanded the policy to include non-homestead properties because business interests convinced the Tax and Budget Reform Commission that they carried a disproportionate share of the overall property tax burden; Constitutional Amendment 1 set an annual ten-percent assessment increase limit for non-homestead property. And, if approved by voters in November 2010, Amendment 3 will reduce that ten-percent limitation to five-percent, potentially crippling Florida's economic future in much the same way that Proposition 13 has contributed to the near bankrupting of the State of California.

In 2008, the Lincoln Institute of Land Policy released a report entitled Property Tax Assessment Limits: Lessons from Thirty Years of Experience. Authors Haveman and Sexton provide numerous examples of legislative actions and the resulting outcomes of property tax reform efforts nationwide. Their research demonstrates that setting limits on assessed values is a deeply flawed approach to offsetting rising property taxes. While assessment caps are proffered as a straightforward strategy for reducing tax bills and slowing the shift in tax burdens to residential property, they often result in higher taxes for the homeowners they are intended to assist, and they can cause unpredictable and unanticipated shifts in tax liabilities. As we already know from Florida's experience with Save Our Homes, by severing the connection between property values and property taxes, assessment limits impose disproportionate tax obligations on the owners of otherwise identical properties, reduce economic growth by distorting taxpayer decision making, and greatly reduce the transparency and accountability of the property tax system as a whole, which contributes to the public's continued ire.

Based on their research, Haveman and Sexton propose alternatives to assessment caps, most of which Florida already enjoys:

- Florida's TRIM notice is a truth-in-taxation measure which lowers the likelihood of unseen tax increases when property values rise but nominal tax rates stay the same.
- Florida law provides for partial exemptions on owner-occupied or homestead properties benefiting residential taxpayers without distorting the market value tax base.
- Florida law has some deferral options that allow taxpayers to delay property tax payments and remain in their homes.
- Havemand and Sexton would argue that Florida needs a robust circuit breaker program to reduce taxes that rise above a certain level of affordability, thus targeting assistance to those whose tax liabilities are out of proportion to their ability to pay.

In 2006, Standard & Poor's published two Public Finance reports on the potential credit rating implications for state and local government stemming from a similar property tax reform proposal in Texas. Some of the concerns expressed in the reports include:

"Appraisal caps have the potential to negatively affect credit quality by impacting an issuer's ability to support their debt…"

"We believe that tax caps will have an impact on the ability of state and local governments to finance capital programs and infrastructure needs and meet their day-to-day operations. Regarding capital improvement plans, municipalities could become more reactive rather than proactive in planning infrastructure and facility needs based on funding availability."

"One of the main strengths of having a higher property appraisal cap is that there is a direct correlation between economic growth and a government's ability to benefit from that growth through taxation. Tax abatement is one of the main incentives that municipalities can offer companies in the region. If appraisal caps are put in place, municipalities won't be able to offer special incentives to keep existing businesses or attract new businesses to the region, as they will be constrained by their revenue sources."

"Local governments have a limited ability to cut operating expenditures since they must provide basic services and infrastructure. If local governments want to meet their infrastructure and basic operational needs, their ability to reap the benefits of economic growth through taxation is perhaps the most important tool in their arsenal."

"Over the long term, limiting this ability could result in budgetary pressures and the accumulation of unmet infrastructure needs," said [S&P credit analyst] Ms. Smaardyk. "Unless alternative revenue sources are put in place to counter the effect of property appraisal caps, the potential for a significant budgetary mismatch remains."

"Again, it is our belief that the implementation of a cap on the growth of property appraisals without a more comprehensive tax reform that addresses all sides of the budget equation could lead to fiscal stress and budgetary pressures that might potentially harm credit quality."

"As with other fiscal challenges, the effect on credit quality will be evaluated on a case-by-case basis," added Ms. Smaardyk. "The big question is whether or not local governments will be able to rise to the occasion and successfully address the budgetary challenges facing them."

In a 1998 paper entitled The Continuing Redistribution of Fiscal Stress: The Long Run Consequences of Proposition 13, prepared for the Lincoln Institute of Land Policy, professor Jeffrey Chapman of Arizona State University also demonstrates that local governments' fiscal autonomy is critical to ensure a vital local economy and that assessment limitations undermine that autonomy.

From a practical standpoint, all one needs to do is study California's economy to see Florida's potential future if assessment caps are maintained. The enactment of Proposition 13 in 1978 has forced California's state and local governments to enact and rely on some of the nation's highest sales and personal income tax rates to fund government operations. Sales and income taxes actually exacerbate the situation because they fluctuate in synch with the economic climate; in boom times, they generate large revenue surpluses, and in recessionary periods they dry up and huge deficits are experienced.

In Florida, what the proponents of Save Our Homes failed to understand was that, once homeowners accumulated a substantial portion of sheltered equity in their homesteads, they would become disinclined to sell. In economic science, this has come to be known as the “lock-in” effect. The lock-in effect was compounded over the last ten years by a dramatic escalation in residential property values. Many homeowners found that they could not afford to relocate, even to a smaller home, because the property tax burden was simply too great; it made the move unaffordable. The lock-in effect of Save Our Homes is what gave political impetus to Florida’s relatively new homestead portability laws.

Understanding the lock-in effect on homestead property owners, it is not difficult to comprehend that prudent owners and operators of income producing properties subject to such a cap will adopt a new investment strategy, similar to the one adopted by the beneficiaries of Save Our Homes… long-term hold. The longer an investor holds his property, the greater his competitive advantage. To wit, the following table illustrates the benefits of such a strategy. By year ten, a property originally worth $10M could enjoy a 34% tax shelter resulting in a $1.61 per square foot competitive leasing advantage.

The Impact of Assessment Caps									
		Assessor's					Tax		Competitive	
Year	Growth	Market Value	Cap	Taxable Value	Sheltered	Pct	Rate	Property Tax	Disadvantage	Per SF
1		$ 10,000,000		$ 10,000,000	$ -		2%	$ 200,000	$ -	$ -
2	10%	$ 11,000,000	5%	$ 10,500,000	$ 500,000	5%	2%	$ 210,000	$ 10,000	$ 0.10
3	10%	$ 12,100,000	5%	$ 11,025,000	$ 1,075,000	9%	2%	$ 220,500	$ 21,500	$ 0.22
4	10%	$ 13,310,000	5%	$ 11,576,250	$ 1,733,750	13%	2%	$ 231,525	$ 34,675	$ 0.35
5	10%	$ 14,641,000	5%	$ 12,155,063	$ 2,485,938	17%	2%	$ 243,101	$ 49,719	$ 0.50
6	10%	$ 16,105,100	5%	$ 12,762,816	$ 3,342,284	21%	2%	$ 255,256	$ 66,846	$ 0.67
7	10%	$ 17,715,610	5%	$ 13,400,956	$ 4,314,654	24%	2%	$ 268,019	$ 86,293	$ 0.86
8	10%	$ 19,487,171	5%	$ 14,071,004	$ 5,416,167	28%	2%	$ 281,420	$ 108,323	$ 1.08
9	10%	$ 21,435,888	5%	$ 14,774,554	$ 6,661,334	31%	2%	$ 295,491	$ 133,227	$ 1.33
10	10%	$ 23,579,477	5%	$ 15,513,282	$ 8,066,195	34%	2%	$ 310,266	$ 161,324	$ 1.61
11	10%	$ 25,937,425	5%	$ 16,288,946	$ 9,648,478	37%	2%	$ 325,779	$ 192,970	$ 1.93
12	10%	$ 28,531,167	5%	$ 17,103,394	$ 11,427,773	40%	2%	$ 342,068	$ 228,555	$ 2.29
13	10%	$ 31,384,284	5%	$ 17,958,563	$ 13,425,721	43%	2%	$ 359,171	$ 268,514	$ 2.69
14	10%	$ 34,522,712	5%	$ 18,856,491	$ 15,666,221	45%	2%	$ 377,130	$ 313,324	$ 3.13
15	10%	$ 37,974,983	5%	$ 19,799,316	$ 18,175,667	48%	2%	$ 395,986	$ 363,513	$ 3.64
16	10%	$ 41,772,482	5%	$ 20,789,282	$ 20,983,200	50%	2%	$ 415,786	$ 419,664	$ 4.20
17	10%	$ 45,949,730	5%	$ 21,828,746	$ 24,120,984	52%	2%	$ 436,575	$ 482,420	$ 4.82
18	10%	$ 50,544,703	5%	$ 22,920,183	$ 27,624,520	55%	2%	$ 458,404	$ 552,490	$ 5.52
19	10%	$ 55,599,173	5%	$ 24,066,192	$ 31,532,981	57%	2%	$ 481,324	$ 630,660	$ 6.31
20	10%	$ 61,159,090	5%	$ 25,269,502	$ 35,889,588	59%	2%	$ 505,390	$ 717,792	$ 7.18
21	10%	$ 67,274,999	5%	$ 26,532,977	$ 40,742,022	61%	2%	$ 530,660	$ 814,840	$ 8.15
22	10%	$ 74,002,499	5%	$ 27,859,626	$ 46,142,874	62%	2%	$ 557,193	$ 922,857	$ 9.23
23	10%	$ 81,402,749	5%	$ 29,252,607	$ 52,150,142	64%	2%	$ 585,052	$ 1,043,003	$ 10.43
24	10%	$ 89,543,024	5%	$ 30,715,238	$ 58,827,787	66%	2%	$ 614,305	$ 1,176,556	$ 11.77
25	10%	$ 98,497,327	5%	$ 32,250,999	$ 66,246,327	67%	2%	$ 645,020	$ 1,324,927	$ 13.25

Table 1

Assessment limitations create a significant inducement for property owners to invest for the long term, because they create a barrier to entry in an already extremely competitive marketplace.

By way of example, imagine two identical office buildings erected adjacent to one another in the very same year. Imagine also that they are fully tenanted at competitive lease terms with similar creditworthiness. Under these conditions, the taxable value should be the same for each.

Now assume ten years has passed and one of the buildings is sold for its current market value. Under the proposed amendment, the new owner would lose previous cap protection and be taxed based on current market value. The new owner is faced with an imposing competitive disadvantage. To account for this in underwriting the purchase, a prudent analyst would (1) decrease projected achievable rents by the amount of the competitive disadvantage on a per square foot basis, (2) factor in a higher vacancy and collections loss in anticipation of tenant turnover resulting from the associated increase in pass-through expenses, (3) increase the projected real estate tax liability expense as a result of the sale, and (4) increase the discount rate to reflect the additional market risk. All of this contributes to downward pressure on profit margins and therefore on the property's value.

These facts lead us to the inescapable second step that any prudent investor will undertake: the implementation of net leases. In order to maximize the income-producing asset's value, operators will pass-through all expenses that the market will bear. And while this is common practice in many markets, especially for office, retail, and industrial properties, multifamily apartment community operators would be inclined to convert traditionally gross leases to a net format. Like separately metered utilities, renters could become responsible for paying their pro rata share of the property taxes.

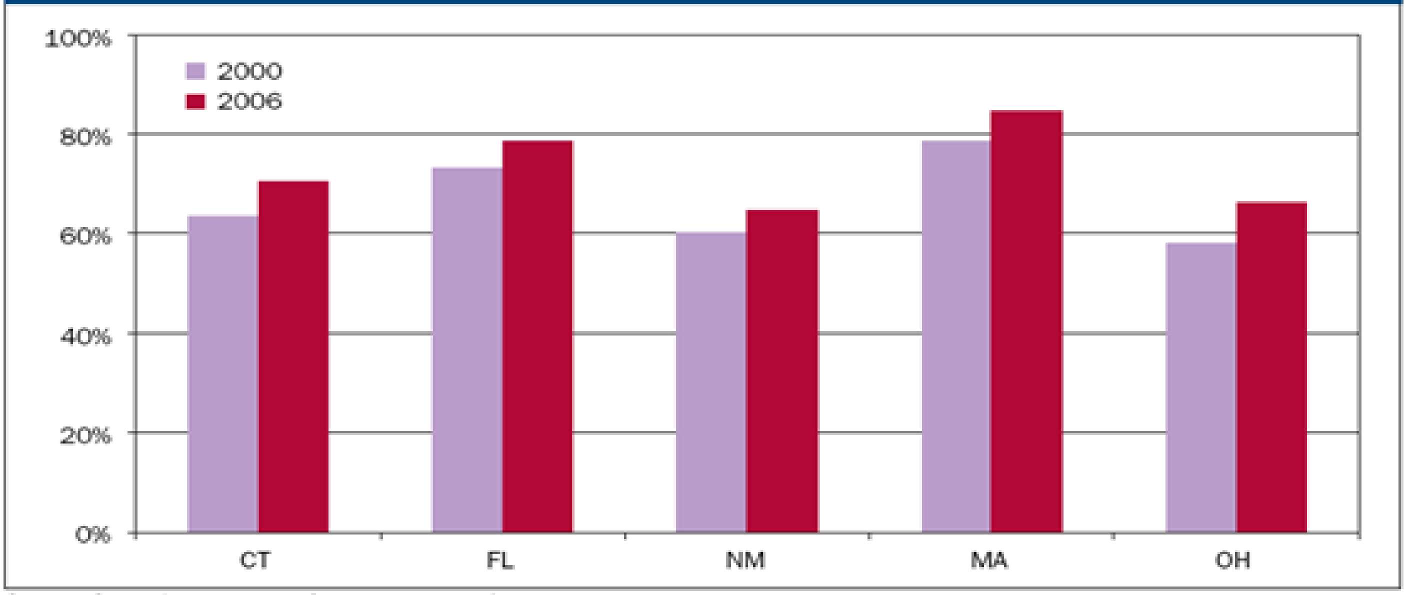
Preliminary comparative analyses based on Table 1 indicate that the impact on value will considerable. Discounted cash flow models of gross rent properties (e.g. full service leases with no expense pass-through provisions, like apartments) evidence value declines of greater than eleven percent when underwritten in this manner. Otherwise comparable net leased property analyses reveal declines of over six percent of market value.

Such dramatic devaluation on ownership transfers also presents a threshold barrier to renovation and new construction and development activities. Significant renovation could subject a property to reassessment under current law. Any new product would be valued at its current market value in the year it came into service, yet it would have to compete for tenants against existing properties which could offer space at significantly lower rental rates. On the other hand, the five percent assessment cap could potentially solve Florida's historic overbuilding problem, because no new development will occur until demand exceeds supply by an amount sufficient to offset the competitive disadvantage that the new properties will face.

As a result, employment and compensation levels for all jobs that revolve around commercial real estate transactions will be negatively impacted. As transaction volume wanes, the demand for appraisers, attorneys, brokers, lenders, title agents and the like will vanish as well. Given Florida's historical reliance on real estate development and transactional activity for economic development, the five-percent cap could be the harbinger of Florida's economic demise.

As evidenced in a chart from the previously referenced Lincoln Institute of Land Policy report, the assessment limitations on non-homestead property shifts the tax burden back towards homeowners, who already shoulder the overwhelming majority of the load.

FIGURE 4
Residential Share of Total Assessed Value in Selected States, 2000–2006



Source: State departments of revenue or taxation.

Despite that Florida's income producing property owners actually write the checks, most economists would argue that the ultimate end user of the property actually pays the taxes. That means that the retail shopper and the clients of office or industrial tenants are the ones who pay the tax, because the costs are passed through to the ultimate end user. And although Florida's tourists contribute their fair share, most of the end users of non-homestead property in Florida are its residents. In the end, assessment limitations deliver:

- lower tax revenues for local government,
- lower municipal bond credit ratings,
- local governments that are hamstrung in adapting to changing economic conditions,
- greater reliance on other types of taxes,
- an unnecessarily complicated system for taxpayers,
- reduced real estate transaction activity,
- fewer jobs and lower compensation for transaction facilitators, and
- they are an impediment to a vibrant economy.

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