NEW YORK UNIVERSITY SCHOOL OF LAW

COLLOQUIUM ON TAX POLICY
AND PUBLIC FINANCE
SPRING 2013

"Modernizing the Property Tax"

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March 5, 2013 (Tuesday)
NYU School of Law
Vanderbilt Hall-208
Time: 4:00-5:50pm
Number 6

SCHEDULE FOR 2013 NYU TAX POLICY COLLOQUIUM
(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 22 – David Kamin, NYU Law School, "Are We There Yet?: On a Path to Closing America's Long-Run Deficit."

2. January 29 – Edward McCaffery, USC Law School, "Bifurcation Blues: The Perils of Leaving Redistribution Aside."

3. February 5 – Jake Brooks, Georgetown Law School, "Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax."

4. February 12 – Lilian Faulhaber, Boston University School of Law, "Tax Expenditures, Charitable Giving, and the Fiscal Future of the European Union."

5. February 26 – Peter Diamond (with Emmanuel Saez), MIT Economics Department, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations."

6. **March 5 – Darien Shanske, University of California at Hastings College of Law, "Modernizing the Property Tax."**

7. March 12 – Dhammika Dharmapala, U. of Illinois Law School, "Competitive Neutrality among Debt-Financed Multinational Firms."

8. March 26 – Sarah Lawsky, University of California at Irvine Law School, "Unknown Probabilities and the Tax Law."

9. April 2 – Alan Viard, American Enterprise Institute, "Progressive Consumption Taxation: The Choice of Tax Design."

10. April 9 – Brian Galle, Boston College Law School, "A Nudge is a Price."

11. April 16 – Leslie Robinson, Tuck Business School, Dartmouth College, "Internal Ownership Structures of Multinational Firms."

12. April 23 – Larry Bartels, Department of Political Science, Vanderbilt University, "Inequality as a Political Issue in the 2012 Election."

13. April 30 – Itai Grinberg, Georgetown Law School, "A Governance Structure to Mediate the Battle Over Taxing Offshore Accounts."

14. May 7 – Raj Chetty, Harvard Economics Department, "Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark."

Modernizing the Property Tax

Darien Shanske[*]

Abstract

It is commonly and correctly claimed that our national tax on income systematically undertaxes the income derived from owner-occupied housing. It is a truism of the fiscal federalism literature that the real property tax should be assigned to the lowest level of government. Because the real property tax is (largely) a tax on the income derived from owner-occupied housing, it appears that, in practice, our federal government has appropriately ceded this part of the income tax base to local governments.

This theoretically satisfying ex post rationalization for our current system has become increasingly frayed as the local real property tax has declined and the federal housing subsidy has, if anything, increased. This decline in the property tax has had other unfortunate consequences, such as increasing state and local revenue volatility. But, even if unfortunate, perhaps the relative decline of the property tax was inevitable, caused, for instance, by shifts in the property tax base? It seems too early to be so pessimistic. After all, the taxes that have increased as the property tax has declined are collected much more efficiently. For instance, both the sales tax and the income tax utilize third parties (e.g., employers report one's income), and the income tax also uses withholding. Withholding is of particular import given the well-known difficulties that most of us have budgeting.

There is little reason that property taxes could not be withheld from income, especially in the majority of states with income taxes - indeed this is a service essentially already provided by many mortgage providers (through escrow). A property tax withholding regime instituted more broadly would not only ease budgeting for both taxpayers and local governments, but administering the property tax along with the income tax could improve the property tax. Specifically, withholding in connection with income allows for the property tax to respond effectively to the liquidity and progressivity concerns that plague the property tax. For instance, circuit breaker-type protections could be instituted directly through the income tax. Such a regime of incorporating income tax elements into the property tax would let "homevoters" respond directly to the relative merits of proposed projects without concern that they must insure themselves against future liquidity problems. These reforms could thus lead to increased local funding of good projects. In short, states and localities have allowed a revenue source to wither because it is collected poorly even though it is one that could possibly significantly mitigate their revenue problems, particularly as to volatility. The federal government should be concerned with the decline of the property tax not only because of this increase in state and local revenue volatility, but because of the reduced ability of the local property tax to serve as a complement to the federal income tax.

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I. Introduction: Two Universal Principles

It is a truth universally acknowledged that a tax system should be designed in a manner that does not give taxpayers incentives to engage in costly evasions. Thus, famously, a tax on windows was not a very effective tax because taxpayers could avoid building windows or could board up existing windows.[1] A tax on income or on consumption makes more sense because earning income or consuming goods is harder to avoid than building windows. Similarly, the broader the income (or consumption) reached by a tax the better. Only taxing *some* consumption (particularly when there are close substitutes to consume), say of chocolate versus vanilla,[2] will lead to lots of evasion and little revenue. If there can be no evasion because a tax base is comprehensive, then taxpayers can just focus on their other (productive) activities.

It is a truth almost as universally acknowledged that, in a federal system, different tax bases should be assigned to different levels of government according to the benefit principle. The benefit principle states: a government should levy taxes on citizens in proportion to the benefits that citizens demand from that level of government (to the extent possible).[3] The benefit principle aims at symmetry between burden and benefit. This symmetry may be desirable for philosophical reasons.[4] Whether or not one is convinced by the benefit principle in the abstract, it is almost certainly desirable for efficiency reasons.[5] Taxing according to the benefit principle sends a price signal to voters as to the true cost of their preferred programs.[6] And, relatedly, the principle encourages greater local political and economic involvement in the choice and monitoring of local projects (at least to some extent).[7] Applied, this principle indicates that a federal system ought to assign the property tax to lower levels of government, namely to those governments that provide the bulk of the services that benefit property, such as school districts and cities.[8] This is consistent with our common intuition that residential real estate prices are bound up with the perceived value of local public goods, particularly schools.

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[1] HARVEY ROSEN & TED GAYER, PUBLIC FINANCE 369-70 (8th ed. 2008); I summarize these issues in Darien Shanske, *A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement*, TAX LAW REVIEW, forthcoming 2013, at Pt. III.E.

[2] I realize it is controversial to suggest there are any close substitutes for chocolate.

[3] Richard A. Musgrave & Peggy B. Musgrave, PUBLIC FINANCE IN THEORY AND PRACTICE 195 (1973); Jonathan Gruber, PUBLIC FINANCE AND PUBLIC POLICY 231 (3d. ed. 2010).

[4] *See, e.g.*, Richard A. Epstein, *The Ubiquity of the Benefit Principle*, 67 S. CAL. L. REV. 1369 (1994) (support of benefit principle from generally libertarian perspective).

[5] See, e.g., LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP, 16-19, 85 (2002) (more politically liberal commentators seeing a role for benefit taxes in the context of a distribution that is already just).

[6] R.M. Bird & T. Tsiopoulos. *User Charges for Public Services: Potentials and Problems*, 45 CAN. TAX J. 25 (2007). There are other advantages. For instance, benefit taxes do not distort business decisions. William H. Oakland & William A Testa, *State-Local Business Taxation and the Benefits Principle*, 20 ECONOMIC PERSPECTIVES-FEDERAL RESERVE BANK OF CHICAGO 5 (1996) ("[B]usiness taxes which conform to the benefits principle will be neutral with respect to economic development. They place the jurisdiction at neither a competitive advantage nor disadvantage per se.").

[7] See generally WILLIAM FISCHEL, THE HOMEVOTER HYPOTHESIS (2001).

[8] See, e.g., Richard A. Musgrave, *Who Should Tax, Where, and What?, in* TAX ASSIGNMENT IN FEDERAL COUNTRIES 2, 12-13 (Charles McLure ed. 1983).

A. Two Universal Principles in Relation to One Another

How do these two universal principles relate? There could be a significant tension. For instance, property wealth results in income. A comprehensive income tax would tax the stream of income resulting from the property wealth provided by homeownership. To take a non-random example, a comprehensive income tax should tax the imputed income earned by a taxpayer from her owner-occupied housing, i.e., her home.[9] A homeowner is better off to the extent that she does not pay rent, say to the tune of $2,000 per month. It as if a renter were receiving a $2,000/month housing allowance from her employer; in that case the bonus would almost surely be taxable. Thus, assuming a rate of 20%, our homeowning taxpayer should pay $4,800 in additional income taxes for the year on the income we impute to her as a result of homeownership (20% * $24,000/year in saved rent). If a homeowner does not pay this amount, then, all things being equal, the homeowner is benefiting relative to the renter. This is not just a fairness problem; it also distorts the allocation of national resources.

Yet this flow of rental savings is also central to valuing a property for purposes of the local property tax. In this scenario suppose the present value of the $2,000 per month savings yields a home value of $350,000.[10] Assuming a 2% property tax, then our homeowner also owes $7,000 per year in property taxes. If imputed income is taxed at the federal level, as our first principle indicated it should be, then our homeowner is thus theoretically paying income tax on the $2,000 income flow twice – at the federal (income) level and at the local (property) level. This offends our first principle and suggests that our tax system is distorted against homeowning, which would again be a problem as to fairness and allocation of resources.[11]

Of course, the federal income tax does not overburden housing. The federal income tax does not tax imputed income from homeownership[12] and, as is well known, contains an additional large bestiary of benefits for homeownership, including a deduction for paying the property tax.[13] Though surely unintended,[14] perhaps the consequence of these aspects of the federal system is to leave lots of room for local governments to levy property

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[9] It should also tax any increased market value of the home.
[10] Assuming a thirty-year term and a 4% rate. This is a simplified analysis; the example is refined *infra*.
[11] Put another way, this income flowing from owner-occupied housing is a "common pool," which, under this scenario, is being over-taxed by two different levels of government. For a general discussion of the problem, see Michael J. Keen and Christos Kotsogiannis, *Does federalism lead to excessively high taxes?* 92 THE AMERICAN ECONOMIC REVIEW 363 (2002).
[12] And should not, for administrative reasons. *See, e.g.,* Steven C. Bourassa & William G. Grigsby, *Income tax concessions for owner-occupied housing*, 11 HOUSING POLICY DEBATE 511, 527-529 (2000). Note that state income taxes have the same structure, further increasing the possible distortion. It is appropriate for states to cede the property tax to localities for much the same reasons as it is appropriate for the federal government to do so.
[13] Note that this analysis only applies to owner-occupied housing and so I will not be discussing the property tax on *commercial* property.
[14] See Dennis Ventry, *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 72 LAW & CONTEMP. PROBS 233 (2010). Note that the mortgage interest deduction (MID) would be entirely appropriate if the imputed rental income were taxed because it would be a necessary expense. Not taxing imputed income and granting the MID is adding benefit on top of benefit.

taxes. That is, consistent with our first principle, the federal income tax system is aiming to tax the stream of income from owner-occupied housing only once. And, consistent with our second principle, this income from property is being assigned to the local level.

Such a solution is theoretically appealing,[15] especially as a post hoc rationalization, but how should we evaluate its success? I think that we must conclude that the system is not working optimally. The property tax has been in relative decline for decades,[16] even as overall state revenues have increased. Put crudely, voters have placed severe caps on the property tax even as they have increased other taxes – particularly income taxes. The income tax infrastructure has the obvious benefit of institutional economies of scale (i.e., the states can piggy-back on the federal government), but also of being more firmly attuned to the politically compelling ability to pay principle. The income tax has also benefited from advances in approaches to tax collection, especially the use of withholding.

We should be clear on just what an outlier the property tax has become. Though it is well understood that taxpayers have a hard time budgeting, the property tax is typically due in one or two annual payments. This is in contrast not only to other taxes, but also to other large liabilities we incur as consumers. Furthermore, despite the size and import of property tax liabilities, the property tax base remains assessed in a manner that does not assure horizontal equity. That is, voters receive little assurance that they – and their neighbors - are being taxed on a base assessed in the same way for everyone. And, finally, despite the size of property tax liabilities, property taxes are hardly modulated to take into account taxpayer income.

This all suggests that if the local property tax is to properly function within a federal income tax system it should be modernized to incorporate more income tax principles. A modern property tax should be collected like the income tax – withheld – and in a manner that is responsive to concerns about ability to pay and liquidity. A modern property tax should also, like the income tax, take advantage of the information provided by realization events, i.e. sales, to assure the integrity of the property tax base.

There is a paradox lurking in the project of making the property tax more like the income tax. As a complement to the federal (or state) income tax, there is no problem in assimilating the property tax to the income tax, but remember that we also wanted the

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[15] And even roughly empirically plausible – see discussion *infra*. This idea of complementarity between the federal income tax and local property tax is not novel, but I have only seen it discussed in an abstract manner at the end of various analyses focusing on other matters. *See, e.g.*, George R. Zodrow, *Property Tax Incidence and the Mix of State and Local Finance of Local Expenditures*, 48 STATE TAX NOTES 567, 577-78 (May 19, 2008) "([A] primary distortion of the property tax is that it tends to reduce housing consumption. However, that feature of the tax may offset the tax bias favoring the consumption of housing because the federal income tax does not tax the imputed rent on owner-occupied housing although it allows deductions for home mortgage interest (and for property taxes). Thus, it is possible that the housing consumption 'distortion' associated with the property tax actually enhances efficiency."); Wei Cui, *Conceptual objections to taxing resale of residential property under a VAT*, at *36-39 (2012), http://works.bepress.com/wei_cui/12

[16] *See* discussion *infra*.

property tax to remain a local benefit tax. Again, our two universal principles may be in tension. For example, a local benefit tax needs to send market-like signals to homeowners that others might value their property more. Yet liquidity protection dulls this signal.

The rough solution here is for the federal and/or state governments to protect homeowners from *some* of the shocks inherent to the property tax as benefit tax - and only temporarily. Thus property tax burdens beyond a certain point should be deferred, but (usually) not forgiven. Thus, Janus-faced, the property tax could function as both more of a local benefits tax and as more of an income tax than it does currently.

There is another hard question lurking and that is how are these more sweeping automatic circuit breakers to be financed while payments are deferred? Fiscal federalism would suggest that the best source of liquidity would be the federal government. It is the federal government that has the greatest fiscal flexibility, including the ability to borrow, and it is, accordingly, the federal government that is traditionally charged with maintaining the macroeconomic stability of the federal system.[17] A healthier local property tax is better for localities and states in a variety of ways, including increasing revenue stability.[18] Furthermore, a stronger property tax improves the national allocation of resources to the extent that the local property tax needs to fill the abyss opened up in the federal income tax base by all the advantages given to owner-occupied housing.

If the federal government will not commit to provide localities with the necessary liquidity – presumably for political reasons – then the states are the next best option for financing property tax deferral. States are (generally) far more fiscally flexible than localities. But perhaps, again, there is reluctance to commit the resources of this higher-level government. In that case, localities – especially if they band together – could generate substantial reserves through financial engineering. After all, the deferred property taxes will be due at some point and so that future stream of income can be securitized. Assuming that the proceeds of these borrowings are properly controlled, then such a maneuver would essentially mean that localities have off-loaded a fair amount of local real estate risk. This seems highly desirable given the extent to which local governments are already – and by design – tied to their local real estate markets.

To put the whole matter another way, the modern income tax was self-consciously conceived as a step away from the property tax, a step made necessary by the fact that more and more wealth was no longer based on property.[19] And, indeed, the income tax has grown to become our primary national tax. It is ironic therefore that the income tax

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[17] Thanks to Mark Gergen for making this point.

[18] Darien Shanske, *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 VIRGINIA TAX REVIEW 413 (2012); see also generally Yair Listokin, *Equity, Efficiency, and Stability: The Importance of Macroeconomics for Evaluating Income Tax Policy*, 29 YALE J. ON REG. 45 (2012).

[19] *See* Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the US Income Tax*, 52 UCLA L. REV. 1793, 1832-35 (2004). Note that despite their opposition to property taxes in general, these early supporters of the income tax did see a special role for the real property tax at the local level. *Id.*

now requires that the archaic property tax be modernized in order for the income tax itself to function better. But that is what I am arguing.

B. The Specific Proposal and its Specific Merits

The theoretical points at the heart of this paper are particularly relevant because of the practicality of a specific set of reforms that will allow the local property tax to serve as a better complement to the federal income tax. In this paper I will develop one interlocking set of reforms that I believe hold both theoretical and practical promise.

The first and fundamental reform would be to institute monthly withholding of property taxes from taxpayer income. This withholding could be applied through the state or federal income tax system or in cooperation with other intermediaries, such as banks. Because the property tax and income tax systems would now be integrated, the next reform is to put in place automatic circuit breakers. That is, property taxpayers would be assured that their property tax burden will never exceed a reasonable percentage of their income; any property tax owed beyond this threshold would be deferred. Upon final sale, there would be a grand reconciliation. At that point, any deferrals and under-assessments would be due – or, alternatively, over-assessments would be refunded. Any additional amount due on a profitable sale should not be overly burdensome, especially given the subsidy granted to homeowners at the moment of a profitable sale by IRC § 121's capital gains exclusion.

If property tax payments are to be deferred, then the question becomes how are local governments to operate in the meantime? As already discussed briefly above, the most elegant solution would be for the federal government to provide the deferred taxes to local governments, collecting the amount eventually due through the federal income tax. This liquidity could also be provided by the states or by the localities themselves.

This multi-tiered proposal would have a number of specific advantages. First, it is generally understood that people have a hard time saving and budgeting.[20] The property tax, rather uniquely, is collected in one large lump sum once or twice a year and thus poses a particular budgeting problem. This common sense intuition about savings, confirmed generally in the behavioral finance literature, has now been demonstrated in the particular case of the property tax.[21] Withholding would thus ease a cognitive burden on taxpayers.

[20] *See, e.g.*, Lee Anne Fennell, *Hyperopia in Public Finance in* BEHAVIORAL PUBLIC FINANCE 141, 148-52 (Edward J. McCaffery & Joel Slemrod eds. 2006) (summarizing literature, including discussion of overwitholding as a form of savings, and demonstrating that this phenomenon appears overdetermined in terms of cognitive biases).

[21] *See, e.g.,* Nathan B. Anderson & Jane K Dokko, *Mortgage Delinquency and Property Taxes*, 52 STATE TAX NOTES 49, 57 (2009) ("We interpret the trend break around property tax due dates as suggesting that the payment shock associated with property tax bills accelerates the pace of mortgage delinquency outcomes."); see also discussion infra. An additional line of evidence observes the popularity of property tax escrow, which is a kind of commitment device. Why would consumers agree to commit to savings devices if they did not also understand that they would find savings challenging? *See e.g.*, Marika Cabral & Caroline Hoxby, *The Hated Property Tax: Salience, Tax Rates, and Tax Revolts*, (2010) (unpublished

Second, regular withholding places the property tax into a more apt deliberative context relative to other taxes and expenses. Whether it be other large taxes – income or sales – or other large or regular purchases, say for a car or utilities, consumers are accustomed to making smaller payments, and they often opt to make these payments automatically. This change should enable sounder deliberation about property taxes because it mitigates anxiety caused by well-known and general cognitive limitations.

Third, the property tax is not keyed to an individual's income and therefore in case of an income shock (e.g., unemployment) or just a lifecycle change (e.g., retirement), the property tax can become an extraordinary burden. Current structural protections, such as circuit breakers one needs to file independently, are undertutilized.[22] This creates an incentive for local "homevoters"[23] to self-insure against liquidity risk by voting against the property tax even when they might otherwise recognize that a project is worthwhile.[24] It is particularly important to make such reforms soon because an aging population generally becomes less willing to fund local public goods like education.[25] A "withholding plus circuit breakers" reform further enhances the quality of deliberation at the local level because it mitigates the need to vote for self-insurance as to liquidity. Such individual liquidity concerns, however legitimate, have nothing to do with evaluating government services or projects.

Fourth, administering the property tax fairly remains a problem. It is inherently challenging to value a property that has not changed hands for some time. In addition, there are increasing – and not surprising – findings that assessments are not only often incorrect, but incorrect in ways that systematically favor privileged groups who are more likely to appeal their assessments.[26] Final reconciliation thus enhances the real and

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draft, Stanford University and National Bureau of Economic Research), http://economics.stanford.edu/files/Hoxby3_2.pdf. (on popularity of tax escrow generally); ICF Macro, Summary of Findings: Design and Testing of Escrow Disclosures (Jan. 28, 2011) (limited survey evidence on consumers' voluntary embrace of escrow); William J. Congdon et al., *Policy and Choice: Public Finance Through the Lens of Behavioral Economics*, at 29 (articulating this general theory); Joel Slemrod, *Show Me the Money: The Economics of Tax Remittance*, at 13 (2007) (working paper) (tax escrow as efficient contracting around an inefficient statutory default).

[22] David Baer, *Awareness and Popularity of Property Tax Relief Programs* (AARP 1998). Note that the findings of the report indicate that low visibility was only one reason for the low utilization. See discussion infra.

[23] This is William Fischel's phrase. WILLIAM FISCHEL, THE HOMEVOTER HYPOTHESIS (2001).

[24] Nathan B. Anderson & Andreas Duus Pape, *An Insurance Model of Property Tax Limitations* (2007) (working paper) (developing this theory in a formal model and providing evidence of significant property tax liability volatility).

[25] *See, e.g.*, Randall Reback, *Local Tax Price Discrimination in an Aging Society* (2009) (working paper) at 22 ("This paper's results reveal that a rising elderly population share has a negative impact on locally funded public school operating revenues, unless elderly homeowners receive substantial state-financed reductions in their marginal local tax prices."). Note that Reback's evidence also suggests that more visible breaks for the elderly could be more effective because visible, even if under-utilized. *Id.* at 21. That is, the fewer people who use them appreciate them more. We will return to this issue infra.

[26] *See, e.g.*, William M. Doerner, *An Empirical Critique of the Property Tax Appeals Process*, at 19, http://artsci.wustl.edu/~cre/ihlanfeldt_paper.pdf (Working Paper) ("To the extent that the goal of the

perceived integrity of the property tax system – in the end, the correct values will be known and will inform the final tax due.

Fifth, local governments, even more than state governments, have very limited revenue flexibility in a crisis.[27] Local governments generally operate under balanced budget rules and are often given the power to raise a relatively narrow band of taxes and fees. Depending on how it is structured, this proposal should create greater state and local fiscal flexibility – either through the creation of local reserve funds or through federal lending to stabilize local property tax collections during fiscal crises when many taxpayers are entitled to property tax deferral.

Altogether, these improvements to a property tax collection system that has not much changed for over a hundred years will address two key local government riddles: Why do citizens typically prefer local government expenditures to other expenditures, but dislike the property tax, the most sensible way to fund local government, more than citizens dislike other taxes?[28] Also, why, if citizens could use the tools of *local* democracy to lower their property taxes, have they consistently acted to put in place draconian property tax limits at the *state* level?[29] It is suggested here that the property tax's anachronistic administration is at least a partial answer to these riddles.

Enhancing local political economy could thus have far more than local consequences. After all, it is (reasonably) feared that anything resembling the current package of government services in the US cannot be supported with the current set of US taxes. From this perspective, what the US needs is more "fiscal space."[30] Fiscal space is defined as "the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government's financial position." Though enhancing local political economy, these reforms could expand our fiscal space in a number of ways. I will focus here on expenditures on infrastructure.

The United States has hundreds of billions of dollars – indeed likely trillions - in unmet infrastructure needs.[31] Many of these projects represent low hanging fruit in that they are likely to yield a good return on government dollars even compared to private

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appeals process is to rectify incorrect assessments, it is falling considerably short. A relatively small percentage of the homeowners who receive AV reductions end up with correct assessments.")

[27] Brian Galle & Kirk J Stark, *Beyond Bailouts: Federal Tools for Preventing State Budget Crises*, 87 INDIANA LAW JOURNAL 599 (2012) (on general problem for states).

[28] *See, e.g.*, Cabral & Hoxby supra. One could maintain that the answer is that citizens simply do not connect local revenue sources with local public goods and indeed in many cases, as in California at the present, there currently is little connection. But given that there was – and in many cases is – a connection, why has the relative shine of local public goods not reached their funding source?

[29] For a similar statement of the riddle see Anderson and Pape supra.

[30] Peter S. Heller, *Understanding Fiscal Space*, IMF Policy Discussion Paper 05/4 at 3 (2005).

[31] *See* REPORT OF THE STATE BUDGET CRISIS TASK FORCE 72-84 (2012), http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

investments.[32] In many cases, neither the need nor the means for constructing the project are controversial; this should not be surprising since so many of the projects essentially involve rebuilding existing infrastructure. Again, spending more on wealth enhancing projects creates fiscal space the way that, for an individual, shrewd investing of current income creates fiscal space in the future.

The United States has a (relatively) uniquely decentralized means of financing infrastructure construction. States and localities, especially localities, play a particularly important role in the US. There are sound, if not airtight, theoretical reasons for this choice of institutional design. Yet these theoretical questions are somewhat beside the point because the system we have is not a matter of design or current choice, but of historical development and hard political and legal fact, and it has worked fairly well. That is, the typically American system of public finance built vast amounts of infrastructure and it did so with very few defaults.[33] Of course, it is just this system that has now failed to finance the beneficial projects just referenced. Thus one underexplored means to create fiscal space is through leveraging our decentralized system to again produce lots of infrastructure. It should be observed that not all countries have a property tax system that could even possibly be leveraged in this way,[34] and thus vibrant state and local financing of infrastructure could be an American competitive advantage.

Here is a simple example of how this can work. Special assessments are levies placed on specific properties to fund specific projects that benefit those properties. Special assessments are generally collected with the property tax and, like property tax increases, are often subject to some voting procedure beyond the approval of a local government's governing body. Until the Great Depression, special assessments were a major contributor to local public finance.[35] The reforms outlined above would also apply to the special assessment, which means that homevoters would not need to worry that, should they approve a new assessment, they will be threatened with liquidity problems down the road. Both academic research, my anecdotal experience, and common sense all indicate that there is likely to be an important local constituency who will be opposed to all

[32] BRETT M. FRISCHMAN, INFRASTRUCTURE: THE SOCIAL VALUE OF SHARED RESOURCES 19-23 (2012) (summarizing recent consensus on the positive rate of return from infrastructure, though scale is contested). Frischman's general (and convincing) argument is that governments will often do better maintaining infrastructure as a commons rather than engaging in more downstream and targeted subsidies. See, e.g., id. at 111-12. Putting the reasoning very simply; a superior public education system, for example, can produce positive results through many channels, including unexpected ones. A targeted subsidy, on the other hand, is making a much more direct "bet" using limited public resources. The types of infrastructure likely to be spurred by, for example, a revived special assessment system, are largely consonant with Frischman's preferred approach.

[33] Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises in* WHEN STATES GO BROKE (Peter Conti-Brown & David A. Skeel, Jr. Eds. 2012).

[34] *See, e.g.*, Enid Slack, *The Property Tax … in Theory and Practice* 4-7 (Institute on Municipal Finance and Governance, Munk School of Global Affairs, University of Toronto September 2010) (though relatively small in the United States [less than 3% of GDP] and lower than it was, the property tax is still more utilized in the US than in most of the rest of the OECD).

[35] Darien Shanske, *Attention Carbon Auditors: There's Low-Hanging Fruit in the PAB Regs*, 127 TAX NOTES 693 (2010).

special assessments simply on liquidity grounds. Whether mitigating this concern will shift the median voter such that an appreciable amount of new projects would be approved is an empirical question that I only have intuitions about, but one worth exploring, especially since these reforms make sense anyway (e.g., in easing taxpayer burdens and stabilizing local revenue).

II. Background

A. Treatment of Owner-Occupied Property

A theoretical discussion of an ideal income tax begins with the Haig-Simon definition of taxable income, which defines taxable income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period."[36]

Here is how this definition would apply to owner-occupied housing: When I consume a house that I own, I am benefiting both from consuming housing and, often at any rate, from some return on my investment. In an ideal income tax world, the income tax system would impute to me a certain value representing how much housing I consumed. The system would also assess how much my investment in housing had appreciated and tax me on that gain.

If the income tax system does not levy taxes on these types of income generated by housing, then essentially this narrow category of income is not being taxed with the result that more people should be attracted to this kind of income and/or those who are excluded from earning this kind of income are at a permanent disadvantage. To add to the simple example from the introduction, A and B both earn $100,000/year and both live in identical homes. However, A owns her home and B rents his. Assuming an effective tax rate of 20%,[37] they both have $80,000 to spend after taxes, but this is a false equivalence because B is also paying rent – $2,000/ month – and so, in fact, B has much less ability to consume or invest, i.e., he has $56,000. It is as if A, the homeowner, were given an additional $24,000 to spend tax free. The disparity is heightened if one supposed that A's home has increased in value this year, say by $5,000.

It turns out that the federal income tax does not tax the imputed income of owner-occupied housing, nor does it tax the annual appreciation of assets unless there is a realization event (typically, a sale). Both are defensible choices from the perspective of administrative convenience. Less defensible are additional advantages given to the

[36] *See, e.g.*, HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); *see also* Joseph Bankman & Thomas Griffith, *Is The Debate Between An Income Tax And A Consumption Tax A Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377 (1992) (example of this definition as the classic starting point).

[37] For the reasonableness of using 20% as an average federal tax rate for homeowners, see, e.g., Congressional Budget Office, The Distribution of Household Income and Federal Taxes, 2008 and 2009, at 14, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-06-11-HouseholdIncomeandFedTaxes.pdf (middle three income quintiles hover below 20% for last 20 years, while top quintile a bit higher).

homeowner, such as a deduction on her mortgage interest,[38] a sizable exclusion of capital gains when she does sell (assuming there are gains), and a deduction for property taxes. In short, and as is well known, the current treatment of housing violates our first universal principle because a sizable portion of the income tax base is being undertaxed.

But maybe the situation is not so unbalanced. A, the homeowner, is responsible for the local property tax. This tax might be sizable. Returning to our initial example, A may owe $7,000 in property taxes on her $350,000 home. This does not perfectly restore horizontal equity, as A's property taxes will almost always be less than B's rent. If this were not so, then B's landlord would be losing money on her property, which is not a situation that can last long.

And so, though the local property tax tends to mitigate the problems created by not taxing imputed income, it is only a mitigation measure because properly imputed rent should generally be larger than the local property tax. Still, given that the federal government can probably not practically tax this imputed income, this mitigation is certainly not trivial. Indeed, some back of the envelope calculations suggest that significant complementarity already exists. The Bureau of Economic Analysis calculates the "Imputed rental of owner-occupied nonfarm housing" annually. In 2010, the BEA estimated this value to be $1.2 trillion.[39] If one assumes that the property owners who were not taxed on this amount had an average effective tax rate of 20%,[40] then the federal fisc lost $240 billion, assuming counterfactually that such a tax increase could possibly have been imposed politically (and without changing anything else). The BEA reported that local governments collected $422.5 billion in property taxes in 2010.[41] This suggests that local governments collected *more* in property taxes than the federal government ceded in taxing imputed income, but this is not so. This is because the BEA's number is for *all* property tax paid, including on commercial property, and we are not concerned with such properties because there is no imputed income issue there. A team from Ernst and Young calculated that businesses paid about $250 billion in property taxes in 2010,[42]

[38] *See, e.g.,* Dennis J. Ventry Jr., *The Fake Third Rail of Tax Reform*, TAX NOTES 181 (Apr. 9, 2012) (focusing on the MID).
[39] BEA, Table 2.5.5 Personal Consumption Expenditures by Function (last updated Aug. 2, 2012); *see also* James R. Follain et al. *The Preferential Income Tax Treatment of Owner-Occupied Housing: Who Really Benefits?* 4 HOUSING POLICY DEBATE 1 (1993) (similar analysis, though not focusing on the property tax and deriving lost federal revenue using American Housing Survey Data and then comparing it for consistency with the BEA figures).
[40] *See* CBO *supra* and Follain *supra* at 13.
[41] BEA, Table 3.21. Local Government Current Receipts and Expenditures (last updated October 4, 2012). States collect a much much smaller amount in property taxes; in 2010, only about $11 billion. BEA, table 3.20.
[42] Andrew Phillips et al., *Total State and Local Business Tax Burden for 2010*, 61 STATE TAX NOTES 835, 836 (Sept. 26, 2011). Happily this $170 billion number is consistent with the total amount of property taxes reported to the IRS as deductible in 2010. IRS, SOI, Table 2.1 Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009 (counting approximately $170 billion in property taxes). Note that property taxes are also paid by non-itemizers and so the almost exact equivalence here is a little jarring. The IRS did find that about $27 billion in these property taxes were found on "nontaxable returns," but I do not think that non-itemizers would necessarily fall in this category. I will try to investigate the matter further.

which left about $170 billion to be paid by individuals in 2010. This number is "only" $70 billion less than our very approximate number of $240 billion that the local property tax would need to collect to be a perfect complement to the federal income tax. Still, if the current property tax is raising about $170 billion from individuals, then an additional $70 billion would represent roughly a 40% *increase* in total real property taxes, and such an increase is not consistent with the historical trend. Of course, there is a reason for imputed income from owning a home to be higher than property tax liability because rent is composed of more than just the property tax.

Furthermore, the federal government in effect cedes even more of the real property tax base to localities. The SALT deduction for the property tax was estimated to cost the federal government $15 billion in 2010; the mortgage interest deduction (MID) $90 billion; the section 121 exclusion $15 billion.[43] To be sure, especially with the MID and section 121, the federal government has goals for these provisions beyond granting localities more space to tax property (e.g., encouraging community-building through homeownership), but there is little question that these (dubious) policies create more space for the local property tax – at least $100 billion in additional space. In fact, the amount of space created is far higher because state income taxes tend to have this same structure of benefiting housing, thus yielding a large portion of the *state* income tax base to localities. California, for instance, estimated the cost of its MID as $4.4 billion in 2010, its capital gains exclusion at $1.1 billion and its property tax deduction at $1.4 billion.[44] So, using our back of the envelope calculations as a benchmark, we can say that, optimistically, the local real property tax is taxing a significant portion of otherwise untaxed imputed income, perhaps as much as 70% ($170 billion/$240 billion). However, given the state and federal tax expenditures granted to owner-occupied housing, there is at least $100 billion of additional space for the local property tax to occupy – or room for almost a 60% increase.[45]

We should note something else about this rough complementarity. Whereas the renter is essentially taxed on all of his income at the *federal* level, the owner-occupier is paying the tax on her imputed income at the *local* level and through a different tax regime, namely the property tax. Can this curious division of the tax base be justified? I believe that it can be.

[43] JCT, Estimates Of Federal Tax Expenditures For Fiscal Years 2010-2014, at 39.
[44] FTB, California Income Tax Expenditures, at 7 (Dec. 2011).
[45] The scale can be put another way. According to the American Society of Civil Engineers, $157 billion in additional infrastructure is required every year from now until 2020. http://www.asce.org/failuretoact/. Suppose the $100 billion more in property taxes were invested annually in infrastructure, say through special assessments. The revival of land-secured financing would thereby have provided more than 2/3 of our infrastructure needs. Historically, such a large role for land-secured financing is not unprecedented. *See* Shanske PAB Regulations *supra*. As a matter of theory, given the direct connection between infrastructure and land value in many instances, it seems plausible that such a role for land-secured financing is justified.

B. Tax Assignment

Our second universal principle, deriving from the theory of optimal fiscal federalism, calls for the benefits of public expenditures and the burdens for paying them to be aligned to the extent possible. Thus, to take a classic example, a school can only serve a limited geographical area (i.e., it is not a pure public good because it is rivalrous) and thus, ideally, that same geographic area should be responsible for funding the school. These local taxpayers will have the incentive and ability to monitor the quality of the school and to assure their tax dollars are spent wisely.

What kind of tax should these local taxpayers pay? The consensus is that it should be a property tax (and ideally a land tax). It is the property around the school that does not move and will impound the value of the school for better or worse. Not only is the property tax theoretically appropriate because the property's underlying value relates to local amenities, but it is relatively administrable at the local level because (real) property is difficult to hide.[46]

Thus the theory of fiscal federalism indicates that it is wise for the federal income tax system to cede the taxation of owner-occupied housing to the local level. It is homevoters who have a direct interest in whether their local amenity/tax bundles add or detract to the value of their property.

C. What is the Local Property Tax?

The property tax that we are discussing is a tax on the value of real property. We have generally been assuming that the value of real property to a typical owner is the present value of saved rent (which we have assumed represents a property's consumption value), but this is clearly not the only component of property value. Most importantly, property is an asset, an investment, and some part of its value represents the value of the investment. If our primary federal tax were a federal consumption tax, e.g., a Value Added Tax, we would need to puzzle over what portion of a property's value is consumption value and what portion represents investment value. A VAT should only tax consumption value. We do not need to puzzle over this because our primary federal tax is an income tax and that tax should reach both consumption and investment value.[47] Because we wish our property tax to complement our income tax, it is fine if it reaches both consumption and investment value.

Nevertheless, we do need to consider the nature of the property tax a bit more. Suppose that the property tax is simply a tax on a certain kind of investment, namely investment in real property. If that is so, then the theory of tax assignment indicates that there is no

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[46] I develop these and other arguments in favor of the local property tax in Darien Shanske, *How Less Can Be More: Using The Federal Income Tax To Stabilize State And Local Finance*, 31 VIRGINIA TAX REVIEW 413, 430-33, 449-61 (2011); *see also* Enid Slack, *The Property Tax … in Theory and Practice* 1-3 (Institute on Municipal Finance and Governance, Munk School of Global Affairs, University of Toronto September 2010).

[47] *Cf.* Wei Cui, *Objections to Taxing Resale of Residential Property under a VAT*, 137 TAX NOTES (May 22, 2012).

good reason to assign this tax to the local level – to the contrary. On this view of the property tax, often called the "new" or "capital" view, the tax is no different from any other tax on investments and should be evaluated as such. Here is a simplified example of the basic point: Suppose I have $1 million to invest. Being a rational investor, I will choose the best return (given my appetite for risk) net of taxes. I might buy stocks, bonds or real property. I am indifferent between them. All the local property tax does is add costs that many other investments don't have – not only the cost of the taxes themselves, but the transaction cost incurred in discovering a local tax rate, and the uncertainty cost that local political economy might raise that rate. As a tax on capital therefore, the property tax is probably not best administered at the local level.

Thus, it is inherent to the tax assignment argument above that some significant portion of the local property tax does function as a consumption tax, namely a tax that is essentially a price for a particular bundle of local amenities. This is the so-called "benefit" view of the property tax. To illustrate: The primary local amenity to be paid for by property taxes operating as benefit taxes is education. If the property tax is not operating as a benefit tax – i.e., taxpayers just treat it as another tax on capital - then an important channel for aggregating local knowledge, expertise and resources has been lost. It will be maintained in the following section that not only has the property tax declined in absolute terms, but in qualitative terms as well – that is the much reduced property tax is behaving far less like a benefit tax.

D. The Decline in the Property Tax and its Causes

That the property tax has declined as a piece of state and local finance is well known, as are a wide variety of reasons for this decline.[48] Obviously, just in terms of brute numbers, this decline undermines the role of the property tax as an income tax complement. The imputed income resulting from owner-occupied housing has not been in similar long-term decline, though of course the declining property tax is a component of imputed income.

One important reason for the decline has to do with shifts in the economy. There are now many fewer very valuable pieces of industrial property. When there were many such properties the property tax on industrial property could, in effect, subsidize property taxes on residential property. Thus these numbers indicating an absolute decline may be somewhat misleading given our interest in residential housing. Nevertheless, the property tax has declined as a percentage of personal income as well as in absolute numbers.[49]

The shift in the economy is what I would characterize as a necessary driver of lower property taxes in general, but there were many contingent factors that tend to explain the decline, particularly as to residential property. Chief among these was the inability of California politicians to address liquidity problems caused by rapid home value inflation

[48] See generally Shanske, supra note __, at 438-47 (recounting history and offering argument for property tax withholding in outline).
[49] See id.

in the 1970s.[50] The California failure gave birth to Proposition 13, which eviscerated the property tax, and became a model for crude property tax reform across the country.[51] One way to characterize the proposal of this paper is that it represents a more nuanced solution to the problem of liquidity, one which preserves the best features of the property tax. Prop 13 was a contingent event that destabilized our tax system. Here is how it can be otherwise.

Yet Proposition 13 has also been explained as much more than a contingency. For instance, it has been plausibly described as a "revolt of the haves," namely a revolt against increasing redistributive taxation.[52] More specifically, William Fischel has observed how quickly Proposition 13 was passed soon after the California Supreme Court embraced school finance reform (in the *Serrano* decisions) – as soon as the courts violated the primary rule of optimal fiscal federalism, i.e., taking the funding for the primary local public good out of its locale, then voters refused to pay for that public good.[53] Or put in terms of our nomenclature, once the property tax became a mere tax on capital income, then voters opted to reduce it.

If school equalization is fundamentally inconsistent with a vibrant property tax, then it does not matter if we update the collection of the property tax using our best thinking about tax collection so long as school financing remains equalized, at least at the local level. Yet, the causality here is surely not so simple (and the case against equalization so strong), i.e., that *Serrano* caused Proposition 13 and thus nothing but undoing *Serrano* could restore the property tax. More likely, a poorly collected tax became even less tolerable amidst high inflation and school equalization. Thus the first step might be to modernize the collection of the tax. After all, even now, even in California, some property taxes (and property-like taxes) can be directly applied to local schools and local public goods. And there is evidence that there is pent up voter demand to increase these local taxes.[54] My hypothesis is that a more modern system of collection could revive the tax considerably, though I am open to allowing more local funding as a way of spurring it

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[50] I discuss various explanations for Proposition 13 here: Darien Shanske, *What the Original Property Tax Revolutionaries Wanted (It is Not What You Think)*, 1 CAL. J. POL. & POL'Y 18 (2009) (Reviewing ISAAC W. MARTIN, THE PERMANENT PROPERTY TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS (2008)). For a more general related discussion of the import of competent tax collection, see R.M. Bird et al., *Tax effort in developing countries and high income countries: The impact of corruption, voice and accountability*, 38 ECONOMIC ANALYSIS AND POLICY 55 (2008).

[51] ISAAC W. MARTIN, THE PERMANENT PROPERTY TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS 108-120 (2008).

[52] DAVID O. SEARS & JACK CITRIN, TAX REVOLT: SOMETHING FOR NOTHING IN CALIFORNIA (1982).

[53] Fischel, supra note __, at 108-16. As summarized in Shanske Review of Martin supra __, Fischel's univocal explanation has been persuasively critiqued.

[54] Property tax overrides for capital projects in California usually require a 2/3 majority of voters, and such measures do pass. CAL. CONST. art. 13A, § (1)(b)(3); http://www.CaliforniaCityFinance.com/LocalMeasuresSince01.pdf at 3 (between 2000 and 2010 over 40% of local measures requiring 2/3 majorities pass). Yet particularly interesting is the following "natural experiment." Since 2000 school districts require only a 55% majority (in many cases). In the first eight years since the 55% threshold became available, about $25 billion in new bond financing was approved that would not have been approved otherwise, for an average of about $3 billion per year of new financing. ELLEN HANAK, PAYING FOR INFRASTRUCTURE: CALIFORNIA'S CHOICES AT ISSUE 7-9 (Public Policy Institute of California, 2009), http://www.ppic.org/main /publication.asp?i=863.

further. Indeed the two initiatives strike me as sitting well together: we will make it easier all around for citizens to fund their local schools.[55]

There is another even more elemental objection to putting a lot of faith in a revived property tax. William Baumol observed in the 1960s that governments were particularly likely to provide services that suffer from "cost disease." Cost disease is a characteristic of certain labor-intensive activities that cannot be made significantly and consistently more productive through the investment of capital. The classic example involves an orchestra. As many other goods and services have gotten far cheaper to produce (e.g., food and transportation), the investment required to have an orchestra perform a Beethoven symphony has changed little, and thus these labor intensive activities have become relatively more expensive.[56] Health care, policing, and education all look like good candidates for the cost disease. Local governments, which are particularly responsible for policing and education, were and are especially vulnerable to the cost disease since they cannot increase taxes very much because they are in competition with one another.[57] Consider the classic example of a central city competing with its suburbs. Accordingly, Baumol suggested that the federal government intervene to help localities. Arguably, Baumol's prediction came true in the 1970s – local governments, trying to finance the same services at a greater cost, did not lower property tax rates even amidst high property value inflation and not because these were led by leviathan-like bureaucrats always looking to increase the size of government, but simply because the very same services cost more. And thus here we have yet another explanation for the relative decline of the property tax and, if it is correct, it suggests that not much can be expected from reforms.

But this concern misses the point somewhat, even assuming that cost disease played a significant role in preventing local governments from reducing their property tax rates in the 1970s.[58] Operating properly within a system of jurisdictional competition, the property tax as benefit tax is supposed to be a price for a bundle of amenities that taxpayers want. Competition should not whittle away benefits that homevoters are

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[55] To be sure, such an initiative will tend to create additional inequality of the very sort that school finance litigation was (and is) designed to combat. I have worried about this very legitimate concern at length elsewhere. *See* Shanske, How Less Can Be More, *supra* note __, at 458-62; see also *What Might They Talk About at a California Constitutional Convention*, 37 HASTINGS CONSTITUTIONAL LAW QUARTERLY 641, 652-55 (2010). For present purposes, I would just emphasize that these reforms are aimed at making the whole federal system work better. This would mean, for example, that poorer communities can get more out of the property tax because of, for example, the use of circuit breakers. Further, because local finances would be enriched and more stable, states would be in a better position to provide meaningful equalization.
[56] *See generally* W.J. BAUMOL & N.G. BOWEN, PERFORMING ARTS: THE ECONOMIC DILEMMA (1966).
[57] W.J. Baumol, *The Microeconomics of Unbalanced Growth: The Anatomy of Urban Crisis*, 57 AMER. ECON. REV. 415, 423 (1967).
[58] The main explanation I have seen for the failure to reduce rates is that the various overlapping jurisdictions did not/could not/would not coordinate a general lowering of rates. Robert P. Inman, *Financing Cities in* A COMPANION TO URBAN ECONOMICS 311, 323 (Richard J. Arnott & Daniel P. McMillen eds., 2006). Assuming that this was the problem, then clearly some coordination reform should be part of a comprehensive proposal to revive the property tax. Cf. M. J. Jocelyn et al., *The impact of local school property tax reductions on city and county revenue decisions: A natural experiment in Kansas*, 11 PUBLIC FINANCE AND MANAGEMENT 180 (2011) (finding that cities and counties increased their property tax rates after school districts were compelled to lower theirs).

willing to pay for. The easiest example is, as usual, schools. Put roughly, if a school district is not offering quality schools, then parents – if they are able - will send their kids to private schools. Homes in that school district will be discounted accordingly – that is, to reflect that a parent in that district needs to pay private school tuition as well as property taxes. Alternatively, homes in a good school district will command a premium in rough proportion to the saved private school tuition. Either way, the increased cost of schooling will be capitalized into the prices of homes. Local governments should not be at any new disadvantage so long as their revenue source is flexible enough to increase in response to the cost disease in a manner that does not antagonize voters, and this is the project of this paper.[59]

Put another way, the heart of the Baumol insight is that not all segments of the economy respond in the same way to capital investment. Education appears to respond less than, say, manufacturing. But it is possible that some of the problem here could be alleviated by capital investment in revenue collection.

To sum up, the property tax has been in decline for decades, including as a benefit tax paid by residential property owners. Some of the decline was surely not just a contingent matter of one state's political failure infecting others. Nevertheless, whatever the reason for the decline, there is reason to believe that a shift to a more modern property tax collection system can mitigate or even reverse the decline. This should be a matter of concern to governments at all levels, including the federal level.

E. The Challenge

What then should our proposal achieve overall? We might put the matter in one of several ways. Perhaps our goal ultimate goal is to increase our national fiscal space. It turns out that our current federal income tax is systematically under-taxing a type of income – that income flowing from owner-occupied housing -- and this narrowness is inefficient. The local property tax can restore overall balance and do so in a manner that makes the whole federal revenue system operate better, thereby generating more revenue. It could be, however, that improving the operation of the whole system might be our aim rather than the net creation of fiscal space. That is, we would in effect broaden our income tax base and then reduce rates. The first step in either direction is for more local property tax to be collected and for the tax to behave more like a benefit tax.

If the local property tax is to be so revived, then it needs to address the legitimate liquidity concerns that spurred Proposition 13. This is not only a year to year concern, e.g., that a taxpayer does not want to lose her home if she is unemployed for a year. These liquidity concerns are also "lifecycle" concerns, namely that taxpayers could

[59] The key phrase here is "new disadvantage." In general, capitalization studies do not show perfect capitalization of taxes/benefits and so to the extent that homevoter perception is "irrationally" depressing (or inflating) home values, then this proposal does not directly help. Furthermore, to the extent that cost disease is not evenly distributed among public and private schools, say because more capital investment upfront can mitigate the disease or because of peer effects, then this proposal does not directly help with the resulting inequality.

rationally vote against property taxes because they know they will have a smaller income flow in retirement.

This proposal should also take into account advances in the behavioral science literature. Taxpayers have a hard time saving for large lump sum payments in general, and thus the property tax should move away from its current method of collection – once or twice a year in a lump sum. There are an increasing number of studies that suggest the benefits of withholding type reforms in connection with the property tax. In particular Anderson and Dokko have found higher rates of mortgage delinquency around property tax due dates.[60]

Finally, the proposal should increase the actual and perceived fairness of property tax collection.[61]

III. The Reform Proposal

A. Base Case – The Introduction of Withholding

The heart of the reform proposal is property tax withholding. Every month, a taxpayer's employer would withhold an additional amount from the taxpayer's income representing the estimated pro rata share (i.e., 1/12) of that taxpayer's property tax.[62] Though, as further discussed infra, this system could be administered though the federal income tax system, I will assume here that withholding is being instituted by a state with both a property tax and a personal income tax.

The property tax would thus represent another number on a taxpayer's state equivalent of a W-4 [DE 4 in California], the form one fills out when hired to setup withholding.[63] One would just add a box for "property owner" and then blanks for the parcel's county and "APN" (Assessor's Parcel Number). The state agency in charge of withholding, in California the Employment Development Department, would then calculate the proper

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[60] *See* Anderson & Dokko *supra*; see also Nathan B. Anderson & Jane K Dokko, *Liquidity problems and early payment default among subprime mortgages*, Federal Reserve Board of Governors Finances and Economics Discussion Series Working Paper 9 (2011) ("Our regression results demonstrate that loans facing a property tax due date within one to three months after origination have at least 3% percent higher first-year delinquency and default rates than loans that face property tax due date 10 to 12 months after origination."); Sebastian Bradley, *Property Tax Salience and Payment Delinquency* (June 2012) (working paper) (finding increased property taxpayer difficulties making timely payments when property taxes increased as a result of less salient features of the tax) ; Andrew T. Hayashi, *The Legal Salience of Taxation* (Sept. 2012) (working paper) (finding escrowing taxpayers less likely to appeal evaluations); Waldhart, *The effect of increasing the number of property tax payment installments on the rate of property tax delinquency* (2011) (working paper) (increasing to three installments lowers delinquency rate, though more than three installments does not help more); Cabral and Hoxby *supra* note __ (arguing that lower property tax salience leads to higher property tax rates).

[61] *Cf.* Slack, *supra* note __, at 10-12.

[62] This is how the property tax is administered in Sweden and a handful of other European countries. P. K. Brown & M A Hepworth, *A Study of European Land Tax Systems* 50, 323 (Lincoln Institute of Land Policy 2002).

[63] Ca RTC 18662(a) (general withholding authorization), 18663(a)(1) (FTB makes withholding tables available to the EDD).

additional withholding as 1/12 of that parcel's annual property tax as reported by the county.[64] Obviously, this system would require an initial investment in interface between counties and states.

It is tempting to have the county report last year's property tax as the basis for current year withholding, but that might impose hardship to the extent that an individual was still in the midst of challenging an assessment. We want to increase confidence in the system. Thus, in the reform proposed here, the county assessor would report a property tax for withholding that is a result of averaging the last three years of a parcel's assessed value.[65] Once the system is in place, this would seem to be an easy mechanical calculation. Similarly, I would envision that the county treasurer or assessor would use one simple conservative property tax rate when calculating withholding and would then apply the precise rate for the end of year reconciliation.

As property taxes come in to the state through withholding, the revenues would then be disbursed to each county treasurer, and each county treasurer would in turn disburse the revenue to the different entities due property tax by that parcel. Given the number of entities the treasurer needs to pay, this may seem an extraordinary burden, but note that county treasurers have to have the means in place to achieve this disbursement twice a year already and so this reform only requires using the same machinery monthly. Furthermore, states already disburse local sales tax revenue to localities and so the administrative challenge at the state level should also not be prohibitive if the state should opt to disburse the property taxes directly.[66]

At the end of the property tax year, now changed to coincide with the income tax year, each taxpayer would be sent a property tax bill based on their actual current year assessed value (AV) and property tax rate.[67] For most taxpayers, a small balance would be due because their property would have increased in value relative to the rolling average, but this would only reduce their likely state income tax refund.[68] In other words, by integrating the two systems, the burden on taxpayers has been reduced enormously; the taxpayer has never faced a large "unexpected" bill. Indeed this outcome is particularly felicitous to the extent that a taxpayer is receiving a refund because of an itemized deduction like the MID. The federal (or state) refund, partially a subsidy for owner-occupied housing, could then be conceived as almost seamlessly being absorbed by local governments into the property tax base.

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[64] Some additional step would be needed for two-earner households, perhaps each spouse would need to elect a proportion of the property tax that they would like withheld.
[65] *Cf.* Ronald C. Fisher et al., *Implications of Eliminating the Property Tax*, in THE PROPERTY TAX AND LOCAL AUTONOMY 199.
[66] California's Board of Equalization does this on a monthly basis, along with a quarterly "cleanup." http://www.boe.ca.gov/pdf/pub28.pdf at 19.
[67] Ideally, most taxpayers would receive one pre-populated bill a la ReadyReturn. The bill should also arrive with the best possible reckoning of what local property tax dollars have been spent on – e.g., 50% on schools.
[68] This of course depends on how the system is setup, including that the state has an income tax. But, even if the new property tax liability is not covered by a refund, it will still be much smaller than otherwise and is likely due at the same time as the taxpayer is receiving cash from the state or federal governments in the form of a refund.

Here is an example – again note that all the calculations would be fairly simply automated (see chart below). I buy a home in 2000 for $200,000. For the sake of simplicity, we will assume that the assessor has calculated my property's annual appreciation at a steady rate of just under 4%. This means that in 2005 my home's actual assessed value is $241,061, but the value used for calculating withholding is only $223,816 because it is an average of the previous three years. Using an average county property tax rate of 1.25% yields a total annual property tax bill of $2,797.70 per year, or withholding of $233.14 per month. At the end of the year, the county assessor would send me a bill for $134.29, which reflects how much I under-withheld my property taxes and this amount would come out of my income tax refund.

Table 1. Property Tax Withholding Base Case

Assumptions					
Assessor's Appreciation Rate	3.805%				
Acquisition Price	$200,000				
Average Property Tax Rate	1.25%				
Actual Property Tax Rate	1.31%				
			Estimated	Actual	Annual
Year	AV	3 Year Avg	Taxes	Taxes	Difference
2000	$200,000	$200,000	$2,500.00	$2,620.00	$120.00
2001	$207,611	$200,000	$2,500.00	$2,620.00	$120.00
2002	$215,511	$203,805	$2,547.57	$2,669.85	$122.28
2003	$223,712	$207,707	$2,596.34	$2,720.96	$124.62
2004	$232,224	$215,611	$2,695.14	$2,824.50	$129.37
2005	$241,061	$223,816	$2,797.70	$2,931.98	$134.29
2006	$250,234	$232,332	$2,904.16	$3,043.55	$139.40
2007	$259,756	$241,173	$3,014.67	$3,159.37	$144.70
2008	$269,641	$250,351	$3,129.38	$3,279.59	$150.21
2009	$279,902	$259,877	$3,248.47	$3,404.39	$155.93
2010	$290,553	$269,766	$3,372.08	$3,533.94	$161.86
2011	$301,609	$280,032	$3,500.40	$3,668.42	$168.02
2012	$313,086	$290,688	$3,633.60	$3,808.01	$174.41
2013	$325,000	$301,749	$3,771.87	$3,952.92	$181.05

B. Whither Tax Escrow?

Before proceeding, I should acknowledge that it could be objected that the private sector already provides a rough equivalent of property tax withholding through mortgage escrow.[69] In some cases banks and/or the federal government require borrowers to enroll in escrow programs. Indeed, research on mortgage tax escrow indicates that such escrow

[69] *See, e.g.*, Cabral & Hoxby *supra*. According to the 2011 American Housing Survey, of the 76 million owner-occupied housing units in the United States, 48 million, or about 63%, had mortgages. Of the houses with mortgages, about 28.6 million units, or almost 60%, paid their property taxes with their mortgage. Table C-14b-OO-Geography-United States: Additional Mortgage Characteristics - Owner-Occupied Units (NATIONAL).

results in fewer loan defaults, another piece of evidence for the possible benefits of this reform.[70]

There are, however, limits to this private system: it is expensive,[71] it does not apply to all mortgage holders, much less all taxpayers, the revenues do not go directly to local governments – and, most importantly, it does not allow for a wider set of reforms that provides insurance for taxpayers against liquidity and market shocks. And, again, this whole package of income tax-like reforms are what I am proposing will revive the local property tax, making it a better complement to the federal income tax and generally jumpstarting our system of fiscal federalism.

It is to these reforms that we will now turn. I return to discussing how tax escrow could be reformed as a second best solution to implement these reforms in Section __ infra. Thus, for instance, commuters who live in one state and work in another could be required to sign up for tax escrow even if they do not have a mortgage, thus obviating the need for states to withhold for one another.

C. Treatment of Sales

One of the major challenges in property tax collection is assessing the value of the property. Advances in technology aid the evaluation process, but progress is uneven and not only because of the inherent difficulty of valuing properties that may not have been subject to a market transaction for a long time. Demoralizing reports of outright corruption remain,[72] and there are subtle studies that confirm a common intuition that wealthier taxpayers are more likely to agitate for lower assessed values and to do so successfully, even if not correctly.[73]

The gold standard for property value is, of course, a property's price at the moment of a voluntary sale,[74] but most properties do not change hands annually. There have been intriguing proposals, mostly theoretical, to force taxpayers to reveal their true property

[70] *See, e.g.*, Anderson & Dokko *supra*.

[71] Not only do banks collect a cushion, they also generally do not pay interest. They also occasionally forget to pay taxes altogether, thereby incurring penalties. Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POLICY DEBATE 753, 761 (2004).

[72] *See, e.g.*, By Jack Dolan and Doug Smith, *Noguez donor's firm got big cuts in property values*, LOS ANGELES TIMES (July 2, 2012), http://www.latimes.com/news/local/la-me-assessor-20120703,0,2799532.story.

[73] William M. .Doerner, *An Empirical Critique of the Property Tax Appeals Process* 19, http://artsci.wustl.edu/~cre/ihlanfeldt_paper.pdf (Working Paper) ("To the extent that the goal of the appeals process is to rectify incorrect assessments, it is falling considerably short. A relatively small percentage of the homeowners who receive AV reductions end up with correct assessments."); *id.* at 29 ("Our findings indicate that if there are two homeowners—one from a majority white neighborhood and another from a majority nonwhite neighborhood who share the same pre-appeal assessment status—the one from the majority white neighborhood is more likely to receive a reduction in AV ."); Daniel P. McMillen, *The Effect of Appeals on Assessment Ratio Distribtions: Some Nonparamteric Approaches*, REAL ESTATE ECONOMICS, forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1908384; Andrew T. Hayashi, *The Legal Salience of Taxation* (Sept. 2012).

[74] Thus this is not just the market price, but the market price at a moment when, at least roughly, the seller's subjective value is equal to the property's market price.

valuation.[75] The basic idea would be to allow taxpayers to self-assess their property's value, but then to grant the government (or even other private parties) the right to buy the property at that price. I think it is safe to say that there are insuperable practical and legal obstacles to putting all property up for auction every year.[76]

Yet I do not think that we need to give up on taking advantage of actual sales data[77]; integration with the income tax allows for assessed values to be corrected in light of actual sales. Put simply, when a sale occurs, the value can be reconciled with the assessed values a taxpayer actually paid taxes on.[78]

Continuing the example from above, say at the beginning of 2014 I sell my home for $400,000, even though it had been assessed for only $325,000. I bought the house in 2000 for $200,000. It is fairly likely that I have been under-assessed for this entire period. We need an administrable and reasonable way for me to make up the difference at a moment of high liquidity. I propose the following. Over the 13-year period, we can imply an annual rate of appreciation according to the official assessed value of the property, which we can then compare to the actual assessed value. Thus, in this case, a home that appreciates from $200,000 to $325,000 in 13 years has appreciated at 3.81%, but the actual annual rate was 5.48% because the actual value is $400,000. If one assumes a constant annual rate, then it is easy to calculate an annual amount that a property has been underassessed. In this case, the cumulative amount over the full thirteen years is $8,842.34

I propose that some interest rate be applied to the underassessment. After all, it was not free for the government to underassess the property. Furthermore, this is an opportunity

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[75] *See, e.g.*, Florenz Plassmann and T. Nicolaus Tideman, *Accurate Valuation in the Absence of Markets*, 36 PUBLIC FINANCE REVIEW 334 (2008); ITT Community Development Corp. v. Seay, 347 So. 2d 1024 (Fla. 1977) (short-lived example of Florida's ordeal system, here held unconstitutional).

[76] Yun-chien Chang, *Self-Assessment of Takings Compensation: An Empirical Study*, 28 J. LAW, ECONOMICS AND ORGANIZATION 265.

[77] *Cf.* Ilan Benshalom and Kendra Stead, *Realization and Progessivity*, 3 COLUMBIA JOURNAL OF TAX LAW 43, 53 (2011) (arguing against a realization requirement for investment assets, including homes, but accepting that a deferral mechanism for homes might be appropriate).

[78] This part of my proposal is similar to that of Steward E. Sterk and Mitchell L. Engler, *Property tax reassessment: Who needs it*, 81 NOTRE DAME L. REV. 1037 (2005). Note one big difference: Sterk and Engler propose that their final reconciliation process completely supersede more regular reassessments, even if the property tax is conceived as a benefits tax. *Id.* at 1051-52. Though an understandable position given the difficulties of accurate assessment (and measuring benefit), I think this would go too far in destabilizing local finances because it would allow assessed values to get too out of line with market values. This is a problem because even roughly functioning jurisdictional competition requires roughly accurate pricing. In particular, Sterk and Engler assume, with only one dated cite, that recent homebuyers are more likely to use school services (not even the full panoply of local government services) and so reassessment at time of purchase is appropriate. I do not share this intuition, especially dynamically across a wide range of communities and services. Suppose, per Sterk and Engler, a family with children moves into a community with good schools, paying a premium to live there. Thirty years later lets assume these empty nesters truly use fewer services, but without reassessment their property taxes are also not sending them the signal that a new family will pay more to live in that house. Moreover, that new hypothetical family's increased property taxes might be essential to maintaining the schools that brought the first family to the community to begin with.

to give taxpayers less incentive to pursue aggressively low assessments – that is, the market will reveal the truth, and with interest. On the other hand, the flat appreciation percentage method is rather crude (though it should even out), we do not want to cause new liquidity problems, and the system is designed to reduce administrative costs through requiring fewer assessments. I therefore propose a rate that is likely to be systematically low, say half of the average earnings rate on investments in the local county pool (or state pool). These pools represent how much the government is earning on its money and are a fair measure of opportunity cost, though individuals are likely to earn more on their savings than public entities, on average (because of restrictions to safe investments) – especially given a 50% discount. And so, in our example, if we assume the county earned 3% interest on average over this period,[79] then the total amount due grows to $9,413.91, which is still a small percentage of the $200,000 in capital gains I would earn.

Table 2. Base Case with Sale

Assumptions						
Assessor's Appreciation Rate	3.805%					
Acquisition Price	$200,000					
Sales Price	$400,000					
Actual Appreciation	5.48%					
Average Property Tax Rate	1.25%					
Actual Property Tax Rate	1.31%					
County Investment Rate	3%					
Year	AV	Actual Taxes Paid	Estimated Actual AV	Estimated Actual Taxes Owed	Difference	Cumulative With Interest
2000	$200,000	$2,620.00	$200,000	$2,620.00	$0.00	
2001	$207,611	$2,620.00	$210,953.22	$2,763.49	$143.49	
2002	$215,511	$2,669.85	$222,506.30	$2,914.83	$244.98	$390.62
2003	$223,712	$2,720.96	$234,692.09	$3,074.47	$353.50	$749.99
2004	$232,224	$2,824.50	$247,545.26	$3,242.84	$418.34	$1,179.57
2005	$241,061	$2,931.98	$261,102.34	$3,420.44	$488.46	$1,685.72
2006	$250,234	$3,043.55	$275,401.89	$3,607.76	$564.21	$2,275.22
2007	$259,756	$3,159.37	$290,484.57	$3,805.35	$645.98	$2,955.32
2008	$269,641	$3,279.59	$306,393.27	$4,013.75	$734.16	$3,733.81
2009	$279,902	$3,404.39	$323,173.23	$4,233.57	$829.18	$4,619.00
2010	$290,553	$3,533.94	$340,872.16	$4,465.43	$931.49	$5,619.77
2011	$301,609	$3,668.42	$359,540.39	$4,709.98	$1,041.56	$6,745.63
2012	$313,086	$3,808.01	$379,231.01	$4,967.93	$1,159.92	$8,006.73
2013	$325,000	$3,952.92	$400,000.00	$5,240.00	$1,287.08	$9,413.91
					$8,842.34	

Remember that this $200,000 in capital gains is, assuming this was my primary residence, likely to be excluded from the federal income tax (IRC § 121)[80], and therefore this is an example of states, through their localities, accessing a part of the income tax base ceded by higher level governments. Again, there is little good reason for the federal government to advantage housing further in this way (or any other), but the evaluation is different if localities are essentially "soaking up" this foolish tax expenditure.

There is another desirable feature to this supplement system, one that I will develop below, but for now let us note that there is a good argument that these supplements

[79] The home, of course, is appreciating at more than half the local investment rate – but note that, if it did not, then there would likely be no excess capital gains.
[80] And state income tax.

should not be treated like regular property taxes because they are not regular property taxes.[81] After all, a properly functioning property tax system should tax at a rate that actually hits a desired revenue target. The rate will presumably take into account the current (perhaps underassessed) tax base and the likelihood of deferral (or the deferral will be immediately made up by higher levels of government). When the supplements (and possibly deferrals) do get paid, they are thus in a sense "new money" for the local government entity. This money needs to be collected in order to preserve horizontal equity between taxpayers and to prevent excessive lock-in effects, but these occasional revenue windfalls should not be included in the regular budget.

Rather, these windfalls should instead be placed in a special "Windfalls for Wipeouts" account that would be used to give refunds to taxpayers who turn out to have been over-assessed (and perhaps for limited additional projects).[82] Refunds could be for significant amounts. Changing the amount I sold my house for to $150,000, I would be owed a refund upon sale of $13,034.09. Note that such a large refund is unlikely to be required because it assumes the assessor applied a 3.8% appreciation rate for thirteen years when property values were actually falling. Even if an assessor were so inclined, why would I not challenge such an assessment at some point? Though large refunds are thus unlikely, it is important, as a matter of perceived fairness and as a reserve in case of a major downturn, that refunds be available and for those refunds to come from a fund comprised of windfalls.

D. Treatment of Special Assessments

Special assessments are a form of property-related levy that are used for specific projects, usually capital. Modernizing their collection could be a big boon to infrastructure finance since much of the infrastructure that needs rebuilding was built (at least in part) using such techniques.[83] Furthermore, assessment financing just makes sense. A new (or improved) piece of infrastructure increases nearby land values, and so why should this increased value not be "captured" and used for the improvement in the first place?[84]

Since special assessments are collected in the same manner as property taxes, there is no reason why these assessments should not be similarly withheld. All that is really necessary is to make certain that the withholding amount reported to the employer at least roughly includes the amount needed for assessments as well.

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[81] Thanks to Nathan Anderson for making this point.

[82] This part of my proposal is a more modest version of that of WINDFALLS FOR WIPEOUTS 31-71 (Donald Hagman & Dean Misczynski eds., 1978) (proposing a Windfalls for Wipeouts Agency which would impose special assessments around *all* government projects; the agency would also seek to adjust payments in connection with changes in local regulations, such as zoning – in other words, the definition of "wipeout" is much broader).

[83] On the history of assessments, see, e.g., Darien Shanske, *Attention Carbon Auditors: There's Low-Hanging Fruit in the PAB Reg*s, 127 TAX NOTES 693 (2010).

[84] For more on the theory of assessments, see, e.g., Darien Shanske, *Putting the California Constitution (Back) to Work: A Blueprint for Clearing Legal Roadblocks to Proper Infrastructure Finance*, 54 STATE TAX NOTES 567 (2009).

Note that the retroactive use of sales information is especially helpful in connection with assessments. A properly priced assessment should cost no more than the benefit of the improvement to a property's market value, but if an assessment is poorly designed, then the final reconciliation at sale can provide some relief.

Here is an example. Again, my home in 2013 is worth $325,000, but my community just approved a $20,000 special assessment on my home for street paving. That additional cost should be capitalized into my home value, meaning that my home should now be worth just $305,000. Yet the $20,000 is supposed to specially benefit my property and should do so at least in proportion to its cost and so my home value should stay at $325,000. Indeed, as discussed at the outset, my property should appreciate in value if this is a good project, i.e. a good investment, say to $330,000. The annual cost of the assessment (say $1,600/year) would be withheld just as above. Any value created by the project not captured by the assessor would be recaptured when the property is sold and the sum deposited into the Windfalls for Wipeouts account. We will deal with any liquidity concerns raised by the new assessment in the next section.[85]

But, before proceeding, let's assume that this was not a good project. Though the assessor just continued to inflate my AV based on a 2013 value of $325,000, my property actually declined in value to $315,000 upon being assessed $20,000. Assume I sell the property in 2017 and the appreciation rate has remained the same. I would then sell the home for about $365,000 even as it was assessed at about $377,000. I have, in short, overpaid on property taxes and in this case presumably because of the poor assessment. Using the same accounting as before, I should receive a refund for my "wipeout," which, under the same assumptions as above, would be about $727. Again, this proposed reform allows for a sort of insurance as to property values.

Table 3. An Underperforming Special Assessment

Assumptions									
2013 AV	325,000								
Assumed Appreciation Rate	3.805%								
Acquisition Price	$200,000								
Sales Price	$400,000								
Actual Appreciation	5.48%								
Property Tax Rate	1.31%								
County Investment Rate	3%								
New Assessment	$20,000								
Annual Assessment	$1,605								
Year	AV	3 Year Avg	Actual Taxes	Assessment	Total Taxes	Actual AV	Correct Taxes	Difference	Cum w/ Interest
2013	$325,000	$301,749	$4,257.50	$1,604.85	$5,862.35	$315,000.00	$5,731.35	$131.00	
2014	$337,367	$313,232	$4,419.51	$1,604.85	$6,024.36	$326,986.67	$5,888.38	$135.98	$268.95
2015	$350,205	$325,151	$4,587.69	$1,604.85	$6,192.54	$339,429.46	$6,051.38	$141.16	$414.14
2016	$363,531	$337,524	$4,762.26	$1,604.85	$6,367.11	$352,345.74	$6,220.58	$146.53	$566.89
2017	$377,365	$350,368	$4,943.48	$1,604.85	$6,548.33	$365,753.52	$6,396.22	$152.11	$727.50
								$706.78	

Note that this insurance is not by any means perfect. After all, I paid a $1,600 annual assessment for five years on an improvement that did not increase my property value, but I only received $727 back. Partially, this limited refund is justified because in the end my

[85] Cf. Donald C. Shoup, *Financing Public Investment By Deferred Special Assessment*, 33 NAT'L TAX J. 413 (1980)(proposing special assessment deferral).

value did appreciate and we can't really be sure why. More importantly, we would not want insurance to be perfect (much less too generous) because that would undermine my incentive only to approve good assessment projects. The insurance function is supposed to mitigate any tendency I might have to excessively self-insure by voting against even a project I thought was likely value enhancing.

F. Automatic Circuit Breakers

But there is a much more direct insurance function that this reform enables - automatic circuit breakers. Circuit breakers cut the amount of liability that a taxpayer owes as a percentage of income,[86] say when the liability is over 10%, as in Massachusetts for certain older taxpayers.[87] Yet these programs typically kick in only through the annual income tax process and only if a taxpayer takes an affirmative action to apply for relief.[88] They are typically underutilized.[89] Withholding allows for the seamless application of circuit breakers more broadly. If we want to protect against liquidity problems in a manner that complements the income tax then we should automatically implement circuit breakers for everyone.

Let's return to our example. I earn $75,000/year and pay a 1.31% property tax rate on a $325,000 home or about $4300/year ($350/month). This is a little over 5% of my income, and so I benefit from the ease and the value insurance function of this reform package, but not from the income insurance. Now, assume I retire in 10 years, in 2023, and now have an income of $35,000. My annual property tax liability at that time ($6,185) is far higher than 10% of my income (it is 17.7%). Now the circuit breaker kicks in and $2,685 of my annual property tax is deferred.

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[86] As Ted Seto observed, income is a clumsy measure here, as there are presumably many individuals with a low income who we would not necessarily view as the natural targets for this kind of protection. This is a matter I will consider further, but it may well be that we need to make do with this clumsy measure in order to make the system easily administrable. To the extent that certain high net-worth individuals will likely be able to benefit from the automatic deferral provided for circuit breakers, this makes it all the more important that the deferral eventually comes due with interest.

[87] Mass circuit breaker - http://www.mass.gov/dor/individuals/filing-and-payment-information/guide-to-personal-income-tax/credits/real-estate-tax-credit.html. Social security counts towards [10%] circuit breaker. http://www.mass.gov/dor/individuals/filing-and-payment-information/personal-income-tax-faqs/personal-income-tax-faqs.html#23

[88] David Baer, *State Programs and Practices for Reducing Residential Property Taxes*, http://assets.aarp.org/rgcenter/econ/2003_04_taxes.pdf (cataloging the many programs available); http://www.cbpp.org/files/3-21-07sfp.pdf.

[89] David Baer, *Awareness and Popularity of Property Tax Relief Programs* (1998).

Table 4. Operation of the Circuit Breaker

Assumptions										
Circuit Breaker	10%									
Starting income	$75,000									
Retirement income	$35,000									
Property Tax Rate	1.31%									
Initial AV	$325,000									
Market Value	$325,000									
AV inflator	3.81%									
Market Inflator	5.48%									
Interest	1.5%									
Year	Income	Property Tax	%	deferral	Total Deferral + Interest	AV	Market Value	Correct Tax	Difference	Cumulative Difference with interest
2013	$75,000	$4,258	5.7%	$0		$325,000	$325,000	$4,257.50	$0.00	$0.00
2014	$75,000	$4,420	5.9%	$0		$337,367	$342,799	$4,490.67	$71.16	$71.16
2015	$75,000	$4,588	6.1%	$0		$350,205	$361,573	$4,736.60	$148.92	$221.14
2016	$75,000	$4,762	6.3%	$0		$363,531	$381,375	$4,996.01	$233.75	$458.21
2017	$75,000	$4,943	6.6%	$0		$377,365	$402,261	$5,269.62	$326.14	$791.22
2018	$75,000	$5,132	6.8%	$0		$391,725	$424,291	$5,558.22	$426.62	$1,229.71
2019	$75,000	$5,327	7.1%	$0		$406,631	$447,528	$5,862.62	$535.75	$1,783.91
2020	$75,000	$5,530	7.4%	$0		$422,104	$472,037	$6,183.69	$654.12	$2,464.79
2021	$75,000	$5,740	7.7%	$0		$438,167	$497,889	$6,522.35	$782.36	$3,284.13
2022	$75,000	$5,958	7.9%	$0		$454,840	$525,156	$6,879.55	$921.14	$4,254.54
2023	$35,000	$6,185	17.7%	($2,685)	($2,685.14)	$472,148	$553,917	$7,256.32	$1,071.18	$5,389.53
2024	$35,000	$6,421	18.3%	($2,921)	($5,645.92)	$490,115	$584,253	$7,653.72	$1,233.21	$6,703.59
2025	$35,000	$6,665	19.0%	($3,165)	($8,895.43)	$508,765	$616,250	$8,072.88	$1,408.06	$8,212.20
2026	$35,000	$6,918	19.8%	($3,418)	($12,447.30)	$528,125	$650,000	$8,515.00	$1,596.56	$9,931.95
2027	$35,000	$7,182	20.5%	($3,682)	($16,315.71)	$548,222	$685,598	$8,981.33	$1,799.63	$11,880.55
2028	$35,000	$7,455	21.3%	($3,955)	($20,515.44)	$569,083	$723,145	$9,473.21	$2,018.22	$14,076.98
2029	$35,000	$7,739	22.1%	($4,239)	($25,061.84)	$590,738	$762,749	$9,992.02	$2,253.34	$16,541.48
2030	$35,000	$8,033	23.0%	($4,533)	($29,970.92)	$613,218	$804,522	$10,539.24	$2,506.09	$19,295.69
2031	$35,000	$8,339	23.8%	($4,839)	($35,259.32)	$636,552	$848,583	$11,116.43	$2,777.60	$22,362.72
2032	$35,000	$8,656	24.7%	($5,156)	($40,944.37)	$660,775	$895,056	$11,725.24	$3,069.08	$25,767.24
				($38,592)					$23,832.94	

Note that the property tax is deferred but not forgiven and so, assuming I sell the home in 2032, I owe the value of the deferral with interest - $40,944. The main reason for this design choice is that the circuit breaker should achieve a balance; it should protect taxpayers from income shocks, especially surprising ones. At the same time, circuit breakers should not undermine the local property tax/price signal completely.[90] The AV, assuming it is correct, along with the property tax rate, reflect the value that others put on this particular property. There is only so much that our federal system should pay for an insurance function that, if made perfect, would dramatically undermine the functioning of the property tax as a benefit tax.[91] Note that in this scenario, part of the reason for the large amount of deferral has to do with the increasing value of my house. I have sold my $325,000 home for $660,775 without needing to pay any capital gains (if I am married), and so paying the $40,000 in deferred property taxes ought not be so onerous.[92]

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[90] Shan has found that higher property taxes do impel elderly homeowners to move to less expensive homes with lower taxes. Hui Shan, *Property taxes and elderly mobility*. 67 J URBAN ECON 194 (2010). As Shan notes, this finding is consistent both with elderly homeowners being motivated by liquidity concerns as well as, possibly, demand concerns – i.e., they want fewer services. *Id.* Looked at from this perspective, what we wish to design are structures that protect homevoters from liquidity constraints, but do not give them perverse incentives in terms of demand (i.e., encourage remaining in a high tax jurisdiction because they do not need to pay the right amount of property tax).

[91] There is evidence that taxpayers do not like the idea of deferral, which is another reason for the under-utilization of these programs. Baer 1998, *supra* note __, at 16-17. This could perhaps create a political obstacle to implementation. That said, I am not sure how much weight should be given to this limited data since the deferral is not applied automatically and universally in the context of a generous circuit breaker.

[92] Forgiveness should be an option if property has declined in value precipitously or if for some other reason the amount of deferred taxes has become so large relative to the value of the home so as to be onerous. Deferral liability should also be coordinated with real estate transfer taxes, which are arguably another (and even more approximate) means of recouping underassessments.

Now, as before, it is likely that my home appreciated even more than the AV would indicate. Sticking to our old numbers, if I actually sold my house for $895,000 in 2032, realizing even more untaxed capital gains (up to $500,000), then I would owe another $25,000 or so as a windfall.

It is a further design question which level of government should be paid the deferral. If the federal or state governments are advancing the funds for the deferral, then clearly these governments should be the ones reimbursed through their respective income tax systems. If it were not possible for this program to be administered through the federal or state governments, presumably for political reasons, then the deferrals should deposited in the local Windfalls for Wipeouts account.[93]

In the end, note how this common scenario has played out. While employed, I paid a manageable amount automatically for property taxes. This amount roughly represented what I would have owed in income taxes on my imputed income, though this revenue has been (for good reason) ceded to localities. While retired, and also consistent with income tax principles, the circuit breakers allowed me to stay in my home if I am willing to pay a price. That is, consistent with the benefit principle, these deferrals are not forgiven. Upon sale of my home, I must pay the value of this deferral (and any undervaluation of the home during my tenure). This makes my partnership with local government more complete, as I am now primarily concerned with increasing the value of my property rather than protecting myself from expected and unexpected liquidity problems. Also, though shielded somewhat from the market pressure, I will pay a price to the extent I decide to consume "too much house."

G. The Case of No Employment Income

What if I have no employment income at all over the course of the year, as in retirement? In this case, there is no income to withhold and so, for such taxpayers, the major benefit of this reform is that it will shift the deadline for payment of property taxes to April 15th and integrate the property and income tax forms, which means that such a taxpayer will have an easier time being protected through a circuit breaker. Ideally, this reform would be combined with a state ReadyReturn-type reform so that the whole tax form, including the property tax liability (and whether it triggers the circuit breaker) is already populated. Even without ReadyReturn, a taxpayer could now input their property tax into Turbotax or give the bill to their accountant and deal with their property taxes at the same time as their income taxes.

But we should note that the number of taxpayers who would not benefit at all from withholding is likely to be relatively small. First, of the 76 million owner-owned households in the United States in 2010, 54 million had wages and salaries as at least a source of income.[94] Second, if the taxpayer is living off entirely off of pensions,[95]

[93] Note that, if administered by the states, placing these deferrals into a state Windfall for Wipeouts account would make a lot of sense, as it would essentially create a limited state rainy day fund.
[94] American Housing Survey, C-14b-OO-Geography-United States: Additional Mortgage Characteristics - Owner-Occupied Units (NATIONAL).

annuities or IRA disbursements, then withholding is the federal default option, and many states follow the lead of the federal government.[96] Thus, the same reform that enables withholding on ordinary income will enable it on retirement income unless the taxpayer affirmatively chooses otherwise.

But what about retirees living entirely (or near entirely) on Social Security? Withholding of federal income taxes due on social security benefits is already available through the Social Security Administration.[97] One reform option is therefore for the SSA to arrange to withhold state income tax and property tax for any state that so requests. Even without withholding, the aforementioned ReadyReturn option could make paying property taxes much easier because the prepopulated income tax form would automatically include the protection of circuit breakers.

What of taxpayers living entirely off of investment income that has not been saved in an IRA and that do not collect social security? These taxpayers are not subject to withholding,[98] though there is a good argument that they should be.[99] It seems fair to surmise that these taxpayers are not particularly likely to be in need of protection from a circuit breaker. Nevertheless, at the federal level, investment income is subject to information reporting and such taxpayers must make quarterly estimated tax payments.[100] States with a personal income tax tend to follow the federal lead and thus a quarterly property tax estimate could be required to be paid based on a quarterly estimate of property tax liability provided by county assessors.

Furthermore, there is no reason that states and localities cannot work with banks to provide for voluntary automatic payments.[101] As with private automatic payment options, the governments would presumably offer a small discount to any taxpayer who voluntarily agrees to pay their taxes automatically. It is even possible for governments to modulate the liabilities they report to participating banks according to a taxpayer's reported income.

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[95] The American Housing Survey reports there were about 15 million household with "retirement or survivor pensions" in 2010. Id. Many such households must also have had income from social security and wages as it seems that many households reported many streams of income. To the extent that there are many streams of income, and withholding is not possible for all of them, this makes the annual reconciliation process more important, but not obviously much more complex than the way the current system reconciles a household's different streams of income annually.

[96] Feds - http://www.irs.gov/businesses/small/international/article/0,,id=104987,00.html; CA http://www.edd.ca.gov/pdf_pub_ctr/de231p.pdf

[97] http://www.ssa.gov/planners/taxwithold.htm. According to the American Housing Survey, about 24 million homeowning households receive social security benefits. C-14b-OO-Geography-United States: Additional Mortgage Characteristics - Owner-Occupied Units (NATIONAL).

[98] http://www.irs.gov/publications/p550/ch01.html.

[99] Lily Kahng, Investment Income Withholding in the United States and Germany, 10 Florida Tax Review 315 (2010).

[100] http://www.irs.gov/publications/p505/ch02.html; https://www.ftb.ca.gov/individuals/faq/ivr/208.shtml.

[101] There is such an option to pay council tax in the UK. See, e.g., http://www.wirral.gov.uk/my-services/advice-and-benefits/council-tax/how-pay.

In the end, it must be conceded that this reform proposal will not have a uniform impact upon all taxpayers and most particularly those who do not rely on ordinary wage income. And, among those taxpayers not consistently impacted will be some seniors living on fixed incomes, and this limits the power of this reform because this is a group in need of protection as to liquidity. This is also a group that is important to local political economy.

Nevertheless, the limitations of this reform should not doom it. First, as to the majority of homeowners with wage income, withholding itself will be an aid. Second, as just outlined, there will be relatively few taxpayers for whom withholding will not be a helpful option. Third, all property-owners will benefit from the improved protection against liquidity and market shocks that an integrated circuit breaker and final sale reconciliation can provide. Finally, we should remember that, in order to create fiscal space, we do not need to turn local political economy upside down. If these reforms shift the local median voter even slightly, then this could have dramatic effects.

IV. Benefits of the Proposal

With the interlocking package of reforms now introduced, it is time to revisit the reasons to adopt them. The first step is to list out the operational reasons why these reforms have the potential to revive the property tax both as income tax complement and as the base for an efficient federal system.

A. Reasons the Reforms Might Revive the Property Tax

1. Liquidity Insurance

As a property owner, it is rational for me to worry about a sudden or planned drop in my personal income or surprising increase in property taxes. However, this rational concern is very tenuously related to my evaluation of whether a special assessment is needed to build a new overpass or whether my general property tax dollars are being well spent on police protection. Thus, looking after my income security, I may vote against a local project that I assess would ultimately be worth the investment. To whatever extent an automatically applied circuit breaker provides me with additional income security, I will be that much more free to vote for projects that are truly value enhancing. And, to the extent that I am now focused on value and not insurance, I am a bit more likely to be involved in careful monitoring of local government spending.

2. Value Insurance

There is a strong argument that homevoters should bear the risk only of *local* property value declines – and particularly those that result from poor local decisions. However, homevoters should not bear the more general risk of housing downturns over which they have virtually no control, or least they should bear much less of it.[102] Currently,

[102] *See generally, e.g.*, Lee Anne Fennell, *Homeownership 2.0*, 102 NORTHWESTERN UNIVERSITY LAW REVIEW 1047 (2008) (outlining issue); Lee Anne Fennell, *Controlling Residential Stakes*, 77 U. CHI. L.

homevoters must bear the entirety of both kinds of risk. The proposal here is modest and only relates to value insurance as to the payment of property taxes based on underlying property value - and not the market value of properties. Nevertheless, this is a step in the direction of shifting risk more appropriately.

In an ideal world, individuals would never pay property tax based on a value higher than a property's actual value at the time. Yet this ideal is unattainable. This is especially true if one accepts that certain infrastructure investments can have unexpected consequences – making one neighborhood more desirable at the cost to another neighborhood, for example. This is the justification underlying the notion of "windfalls for wipeouts." Suppose a public project helps one citizen's property value and harms another's. Assuming the prospectively injured citizen is more vocal, say because of the endowment effect – or that the injury is more concentrated – the possibility of wipeouts might prevent the construction of projects that will produce net societal windfalls. This is especially true if the design of local voting procedures, say use of a supermajority rule, particularly empowers minorities. Final reconciliation of home value will mitigate the cost of local projects that underperform or that harm some owners while providing an overall net benefit.

As with liquidity insurance, any increment of property tax insurance that this proposal provides is an encouragement for local voters to focus on the true costs and benefits of projects. Assuming, reasonably, that there are many such projects, and, more speculatively, that we do not need to shift the median voter very much, then these two shifts could make a significant difference.

3. Rightsizing Salience

Still, one might object that the two channels above are unlikely to amount to much. The sums of money involved in my examples are not large. Yet, in this regard we should remember what we are learning about taxpayer psychology. Individuals in general find it very difficult to anticipate future expenses and save accordingly. They are therefore very sensitive to income shocks; indeed, it would seem hypersensitive.

If we go back to our simple initial cases, we can see why this is so. US median household income for households occupying their home is about $59,000[103] and the median real property tax is about $1,800.[104] Median income translates into about $4,900/month before taxes. The average combined effective federal tax rate has hovered around 20%.[105] To be conservative, let's make the combined federal and state rate 25%,

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REV. at *11-16 (2010) (proposing solutions, including locally administered equity insurance.); *see also* Fischel, *supra* note _, at 268-70.

[103] 2011 American Housing Survey, C-09-OO-Geography-United States: Income Characteristics - Owner-Occupied Units (NATIONAL).

[104] 2011 American Housing Survey, C-10-OO-Geography-United States: Housing Costs - Owner-Occupied Units (NATIONAL).

[105] See CBO supra at 2, 14 (median household income overall is about $50,000 and so owner-occupied housing owners more likely to be in four higher quintiles).

and so monthly after tax income is $3,675.[106] On a monthly basis, the property tax comes out to about $150/month or about 4% of after-tax monthly income. From this perspective, the property tax looks manageable. Indeed, even if this were a high property tax state, with a rate 50% higher than the median,[107] the monthly liability would still be about 6% of US median income (and often the median income is higher in higher tax states).

And yet suppose the property tax is collected in two lump sums, and one of those lumps is due in December right before the holidays. The resulting liability is $900 or almost 1/4 of monthly income. No doubt this liability should not be unexpected, but that is fighting the hypo – we know that most taxpayers will find it hard to have saved the $900 in advance. One presumes the budgeting problem, and resulting anxiety, increase in proportion to the extent one believes one may experience a surprising loss of income or an increase in property tax liability.

Studies that look more broadly at macro-level political behavior tend to confirm the results of these studies of individual psychology. At this point, sweeping property tax limitation regimes are very common. Leaving aside the dubious design of these regimes for a moment, there is, as noted above, a puzzle as to why they exist at all. In the traditional local government finance scenario – and the scenario that was generally revolted from - it is local governments that control property tax liability. Elected officials, say the local school board, set the property tax rate and elected assessors determined property value. If voters were unhappy about either, then they could have elected officials who would change course. Similarly, they could vote down local bond measures that they believed would raise taxes excessively. Given all this local control over property taxes, why did voters feel the need to impose draconian fixed limits at the state level?

One explanation is that voters did find themselves "out of control" in certain cases. If one lived in a large city or county and could not/would not move (i.e., exit), then exercising voice at the state level makes sense.[108] Though this explanation has some power, we should observe that a key fact underlying Fischel's theory that *Serrano* caused

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[106] This example does not address the added complication that these taxes and the mortgage interest are likely deductible. This is not too serious an oversight because ultimately these federal income tax benefits, though potentially quite sizable, will likely only be enjoyed by the taxpayer through a refund. In the meantime, the liquidity problem remains.

[107] The median property tax rate is 1.1.%. 2011 American Housing Survey, C-10-OO-Geography-United States: Housing Costs - Owner-Occupied Units (NATIONAL). The rate is highest in the Northeast, with a median of 1.6%. Id. The median owner-occupied household income in the Northeast is above average however, at $70,000. 2011 American Housing Survey, C-09-OO-Geography-United States: Income Characteristics - Owner-Occupied Units (NATIONAL). It is striking – but not surprising – that the West has a relatively high median household income, $65,000, but a below average property tax median rate of 0.8%. *Id.* The Midwest has a higher than average property tax rate and slightly below average median income. The South has below average property taxes and below average median income. This diversity speaks to likely different uptakes of these reforms nationally. In the Midwest, one could, for instance, surmise that these reforms would primarily protect the property tax from further erosion. By contrast, one would hope that these reforms would spur the West to inch more towards the median.

[108] GARY J. MILLER, CITIES BY CONTRACT (1982).

Proposition 13 is that even wealthier and higher spending school districts supported Proposition 13 and presumably many of these voters were not out of control.[109] Of course, that fact is just as consistent with Proposition 13 as a "revolt of the haves," i.e., homevoters just pursuing a windfall, in contrast to a revolt against *Serrano*.[110] Or, as Stark and Zasloff observe, there is important evidence that Proposition 13 was supported as a matter of political ideology because it was not the case that many of its key supporters stood to gain a great deal from property tax relief or lose a great deal from *Serrano*.[111]

But, again, if not out of control, why should voters seek a "windfall" through reducing the taxes that went towards local (relatively popular) services? Why should ideology turn against such a tax? Fischel's *Serrano* explanation is, at best, a limited explanation.

One emerging and more persuasive explanation for the votes of empowered homevoters is that they wanted to insure themselves against higher taxes should they be unable to affect change via political voice or exit; they wanted every community in which they might reside to have permanently low property taxes.[112] If instituted at the state level, then these reforms would protect homeowners throughout the state; no need to monitor locally or shop between jurisdictions or fill out a circuit breaker application.

I am counting this psychic benefit as separate from the insurance benefits already discussed precisely because I do not think that draconian property tax regimes like Proposition 13 are a rational response to the need for insurance. It is a hyperbolic response caused, in part, by the difficulty that taxpayers have organizing their financial affairs.

It is perhaps too common for commentators, especially legal commentators, to claim that a deep truth about human psychology has been discovered on the basis of a few experiments with undergraduates. I wish to avoid that error. For my purposes, all that is necessary is that recent laboratory experiments are consistent with various natural experiments and common sense. Banks and individuals prefer automatic escrow of mortgage and property taxes and it is easy to understand why. There is some uncertain increment of (irrational) psychic cost that automatic payment ameliorates. And it is submitted that, reducing this cost, along with the rational desire of taxpayers for property tax and value insurance, could have a considerable impact on local political economy.

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[109] Fischel, supra note __, at 112-13.
[110] DAVID O. SEARS & JACK CITRIN, TAX REVOLT: SOMETHING FOR NOTHING IN CALIFORNIA 123-24 (1982).
[111] Kirk Stark & Jonathan Zasloff, Tiebout And Tax Revolts: *Did Serrano Really Cause Proposition 13?* 50 UCLA L. Rev. 801, 833 (2002).
[112] Anderson & Pape supra note __; ISAAC W. MARTIN, THE PERMANENT PROPERTY TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS (2008); Jacob L. Vigdor, *Other People's Taxes: Nonresident Voters And Statewide Limitation Of Local Government*, 47 J.L. & ECON. 453 (2004).

B. Broader Benefits

1. More Efficient Allocation of Capital Between Economic Sectors

Our first universal principle aims to minimize the amount of distortion caused by the tax system. If the tax system taxes chocolate but not vanilla, cars but not scooters, tangible items but not intangibles, then the predictable result will be that capital will flow into the undertaxed activity – and more than would be warranted otherwise. The federal government does not tax over $1 trillion in imputed income annually from owner-occupied housing, and has thrown in additional $100 billion or so in tax expenditures to subsidize this sector of the economy. At this point in our economic history, detailing the serious consequences of super-charging the housing sector should be clear. The local property tax mitigates this misallocation to some degree. If the local property tax were to be improved – and increased – then this mitigation could be more perfect.

2. Improved Functioning of Lower Levels of the Federal System

The theory of fiscal federalism, from which our second principle derived, pertains to the efficient allocation of resources between levels of government in a federal system. It is not efficient for the central government to use general tax dollars on local projects that local property owners would pay for themselves – if the property owners could be assured that the projects would increase their property values. Such assuring takes place through the mechanisms of local democracy and the resources for such projects are raised through local property taxes. If the local property tax has been revived, then the lowest level of our federal system is operating more efficiently, which leaves more flexibility for higher levels of government.

3. Revenue Smoothing

Because the property tax is generally collected twice per year, local governments generally receive their share of the property tax twice per year. Because the expenses of local governments are not similarly distributed, cash flow can be a major challenge. Indeed it is very common for local governments to issue Tax and Revenue Anticipation Notes (TRANs) to tide them over. These transactions are not costless. Though not a major benefit, improving local government cash flow is an improvement that should be noted.

Furthermore, implementation of these reforms should ease local financial volatility between years, and volatility is not costless. Committing to a program and then cutting back sharply is generally more expensive and disruptive than just moving forward with a smaller and more certain budget estimate.[113] A conservative monthly estimate is

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[113] David Gamage, *Preventing State Budget Crises: Redefining "Tax Cuts" and "Tax Hikes"*, 98 CAL. L. REV. 749 (2010).

precisely what the County Treasurer should be able to provide local governments. This stability is primarily because of two things. First, the AV used to estimate withholding is based on an average of the previous three years. Second, we have created, at the very least, a local Windfalls for Wipeouts fund that will pay for any required refunds out of supplements already received. Thus, each local government will be able to budget knowing that they are unlikely to be much surprised in April when the final tax reconciliation comes in – and, if they are surprised, it is likely to be positively.

What of the case of a severe downturn? In such a scenario, many many taxpayers are going to be entitled to defer payment of their property taxes. If the deferral system is being administered by the states or, ideally, the federal government, then these higher level governments should advance localities the value of the deferrals. This would, in essence, be a locally-targeted stimulus plan. There would be no dramatic cuts in local governments at the worst possible time.

What if neither the state nor federal governments funded deferrals – what then? We have observed that it would be possible to bulk up local Windfalls for Wipeouts funds by placing paid up deferrals into these funds along with supplements paid as a result of reconciliation.

Suppose the system I am envisioning had been in place since 2000. By 2009, when county assessors would have owed significant refunds and been hit by large deferrals, the Windfalls for Wipeouts (WFW) fund would have had at least eight good years to be built up by regular deposit of property tax supplements collected when properties were sold at prices above their AV, as well as paid up deferrals. This money would then have been available to pay for refunds and deferrals when the crisis hit.

One might raise two objections to this scenario. First, the funds raised by some counties (or other local governments) might be insufficient because these counties experienced atypically small gains or large losses. For this reason it makes sense for there to be a state-level WFW, consisting of say 15% of all revenues annually deposited in county WFWs. The state fund would represent a (mild) form of fiscal equalization.

A second objection would complain that my example made matters too easy – with eight good years preceding the bad ones. Here is where advances in financial engineering could turn out to be helpful. The money to be raised through supplements and excess contributions could be estimated and securitized, and thus could be available in Year One.

A simple preliminary model for this could be tax increment financing (TIF). In a TIF financing, investors lend an entity (usually a redevelopment agency) money for a project, and the investors are to be paid back by the increased value (tax increment) that the project is estimated to generate. A similar structure could predict the value increases that are ultimately to fill a WFW fund. Yet there is no telling when exactly a property owner will sell a property and thus be liable for the tax supplement or, similarly, when and how a taxpayer will pay back a deferral. This is not an insuperable obstacle.

A model for solving this problem could be the securitization of the national tobacco settlement. State and local governments could at best estimate the payments they would receive from the tobacco companies as part of the settlement, but there was still a market for the stream of these uncertain payments (at a premium, but not an unmanageable one).[114] Investors bought the stream of payments knowing that there was a likelihood they would not be paid on the projected schedule, but accepted that such a failure would not result in an event of default. At the same time, the bonds had provision for "turbo" redemption should collections come in stronger than expected. Aside from providing states and localities with needed cash upfront, these issuances also had the merit of transferring the risk of underpayment (i.e., because of reductions in smoking) onto investors, which is a more efficient and appropriate allocation of this risk.

Similarly, local governments are already at the mercy of their local real estate market in so many ways that transferring some of this risk to investors makes a lot of sense. This is especially true because the WFW funds need funding from the start if they are to be viable from inception. Note that, unlike the tobacco bonds, the proceeds from these WFW bonds should be very tightly controlled, reserved only for compensating for wipeouts, deferrals, and, perhaps, the financing of a very limited amount (in absolute terms) of regional infrastructure.[115]

It would be best for the federal government essentially to serve as a (limited) lender to local government during downturns by covering the cost of deferrals. It would be less good, but still advisable for state governments to play this role. Thus, this whole WFW infrastructure is a third best. I have developed it here because I think politics may well prevent either of the better options from materializing and because advances in financing indicate how a functional local/regional alternative could be cobbled together.

V. Objections

In outlining the proposal, I have responded to the most immediate concerns as to its practicality. In the section that follows I will first address more theoretical and normative concerns with this reform package and will then return to additional administrative concerns.

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[114] There is a lot more to be said about the complexities of the tobacco bonds. Even though many of these bonds are currently providing less than projected revenue, they are not necessarily doing poorly on the secondary markets. http://www.bloomberg.com/news/2012-07-20/tobacco-bonds-rally-with-no-sign-of-2042-mortality-muni-credit.html.

[115] I am imagining that a certain small amount of WFW funds (say not more than 10%), when the total fund has reached a certain healthy size, could be used on a revolving basis for initial funding for select regional projects. The WFW funds could thus operate as (very modest) county infrastructure banks and, as such, any financings they supported might deserve additional state or federal aid because these projects would presumably represent regional priorities.

A. Normative

The normative objections I will consider will not fly directly into the teeth of our two universal principles. That is, I am not sure what to say to an objector who does not think that taxes should be applied in a manner that avoids deadweight loss all things being equal. Similarly, given the brute reality that we live in a federal system – and one that works pretty well – I will continue assuming that we ought to try to make our federal system better through application of the benefit principle.

However, there are two powerful objections I will consider. The first objection would be that withholding is improper when used for the federal income tax and so, a fortiori, broadening withholding to property taxes is improper. After all, the federal income tax could be collected more like the property tax. A second objection argues that it is particularly objectionable to introduce withholding into the local property tax system, whatever the merits of its role in the federal income tax system.

1. All Taxes Should be More Visible

There is a general critique of income tax withholding which runs basically as follows: Withholding does not make paying taxes easier so much as it hides tax liability. Hiding taxes makes it easier for governments to increase taxes and specifically to increase them beyond what the citizenry would want if they were not hidden. And, in fact, one prominent empirical study purports to demonstrate a connection between property tax escrow, which is similar to withholding, and higher property taxes.[116] This line of thinking has proven particularly potent in thinking about replacing the federal income tax with a federal Value Added Tax. A VAT is said to be more hidden than the income tax. Empirical data is adduced to show that VATs are increased by governments more than other taxes. Thus, from this point of view, in implementing these reforms we would be pursuing greater complementing between the federal and local systems in a way that will lead to an unjustified net increase in the size of government.

There are many complexities to be teased out here – too many. I have responded to this kind of argument at length elsewhere and so will not repeat all the responses to this line of thinking,[117] but I will address a few briefly. First, as an empirical matter, it is not at all clear that there is a connection between "hiddenness" and higher taxes.[118] For instance, VAT rates have not been increasing at a rate very different from, for example, American

[116] Cabral and Hoxby at 42-43.
[117] With my coauthor David Gamage. David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX LAW REVIEW 19, 79-98 (2011); see also generally Deborah Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REGULATION 253 (2011). Schenk is particularly helpful in distinguishing salience from transparency and complexity; nothing in this proposal would make the property tax any less transparent or more complex and thus less of a possible topic of political discourse. Id. at 256-61.
[118] Or put another way, we do not know how it is that withholding reduces political salience, if it does. Gamage & Shanske Three Essays, supra note _, at 41-43.

sales tax rates.[119] As for the property tax, the study mentioned above does not consider the mechanism that explains the connection between escrow and higher property taxes. Why assume that property taxes for escrowing taxpayers are higher because "hidden"? It could just as well be that these taxes are thereby more easily budgeted for and therefore need not be planned around through the crude means of simply not approving adequate rates.[120] In short, the plausible empirical intuition here may well be incorrect. Indeed, given that the same authors observe that local government spending is relatively popular, and the by now canonical observations about saving behavior, the intuition that "hidden" property taxes are levied at the "correct" rate seems at least as plausible.

Second, in any event, it is not clear what is meant by the tax being "hidden." It is true that the cost of a VAT is usually built into the display price of goods – unlike American RSTs – but this only means that the VAT has higher *market* salience. That is, consumers only see a tax-inclusive price and so take tax into account right from the start of a market transaction. It is plausible to claim that this higher market salience translates into lower *political* salience – that is, because voters do not see a tax exclusive price they do not fully take into account how much they owe in taxes when they vote. From this perspective, property tax withholding coupled with an annual accounting might reduce the political salience of taxes. But that is not necessarily the case for a VAT and certainly need not be the case for the reformed property tax. There is no reason, that, as part of this reform, local governments should not provide homevoters with a detailed property tax bill detailing local government expenditures. Such a statement could be far more meaningful than an equivalent "invoice" from the state or federal governments.

Third, leaving aside adding such an invoice, and even assuming some voter confusion caused by withholding, at least some politicians will have incentive to make voters aware of their tax burden and, if anything, (any) voter confusion as to how much they actually paid is as likely to lead to over-estimation. Under the proposed reform, the property tax – even if it would become less politically salient – would only become as politically salient as the income tax is now. It is hard for this observer to understand how the income tax could be said to be not politically salient enough for the purposes of political deliberation.

Furthermore one needs to remember that VATs are offered as a reform within a broader context. A federal VAT would be meant to replace most or all of the federal income tax system, a system already characterized by withholding, but also by the AMT and innumerable complicated credits and phaseouts. Would a VAT be less politically salient than what it would replace? Similarly, if the property tax is allowed to continue to wither, then it is likely to be replaced by higher retail sales taxes, personal income taxes,

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[119] John L. Mikesell, *Comparing Operations of Retail Sales and Value Added Taxes*, TAX NOTES 173, 183-83 (Oct. 8, 2012). Nor is it true that the typical VAT is necessarily less politically salient than an American RST, as the tax is broken out on the receipt in both cases. Id. at 181. In any event, there is no reason a VAT could not be imposed in a tax exclusive manner just like RSTs.

[120] Note that Cabral and Hoxby do consider this possibility and try to control for it by measuring whether superior school quality is correlated with higher rates. Id. at 37-38. If it were (and it was not), then better schools might explain higher spending rather than reduced salience. I do not think that this crude estimate of the quality of local government services is adequate for dispensing with this hypothesis.

and perhaps even VATs[121] and so the question is compared to what would salience be reduced?

To this, a critic might reply that a VAT may be no less politically salient than the current system, but the whole system should become more politically salient – perhaps one tax bill once a year. So too the critic might say that it is the property tax, requiring taxpayers to hustle to pay it once or twice a year, that gets political salience correct. It is the income tax that needs to shed withholding.

And now we get to the question of absolute salience. Is one large bill a year from the government really normatively superior? It is hard to believe given the psychic pain we know this would inflict. It is also hard to believe given the very confused signals sent by voters, if bare voter preferences are our pole star. If, instead, meaningful democratic deliberation is our pole star, then this seems a very dubious reform because government services are not doled out once a year. Such a reform seems designed to skew the discussion because voters will be presented with one large bill for a whole year of (often invisible) services.

This is especially true for local governments, which are most likely to provide services that are fungible with what the private market provides. Yet private marketers do not rely on being paid for their services once a year in a lump sum; they make payments easy and emphasize the quality of what they are providing in a way that governments cannot compete with. It is hard to see why it is normatively desirable to systematically skew voter perceptions of the costs and benefits of government services relative to those provided by the private sector. Of course, one could start with an anti-government prior that cannot be addressed here, but note that presumably this concern has something to do with an assessment of what governments can and cannot do well and so there is little reason to distort the discussion from the start with a revenue system designed to be as obnoxious as possible.

2. *Property Taxes Should Be More Visible*

There is a more specific and cogent worry about political salience and the property tax. Remember, reviving the property tax as a better part of our federal system requires that it act more like a benefit tax. It is as a benefit tax that the property tax comes closer to representing the consumption value missed by the income tax, and it is as a benefit tax that local taxpayers, homevoters, use the property tax to make better decisions about the allocation of local resources. But if homevoters do not know the true costs of local government, as they do not understand the costs of, say, the federal government, then they are liable to make all kinds of errors, from approving wasteful projects to rejecting good projects out of suspicion. [122] Furthermore, though as noted above the evidence is far from unequivocal, there is evidence that withholding will reduce political salience. Thus the withholding at the core of the proposed reforms would undermine the

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[121] At least in some form. See, e.g., Texas' Margin Tax.

[122] Brian Galle, *Hidden Taxes*, 87 WASH. U. L. R. 59, 96-97 (2009); see also Congdon et al. supra note __, at 188 (benefit taxes cannot function as benefit taxes if there is inadequate voter uptake of the benefit).

efficiencies of the property tax that we are hoping to capitalize upon. In other words, there is good reason not to introduce a key feature of the income tax – withholding – into the property tax.

In responding to this concern, I will grant the assumption that these reforms will reduce political salience even though, as noted above, that is far from clear, especially if this reform were to include a well-designed annual local government invoice.

a. Initial Responses

Prima facie it should be remembered that this normative argument against these reforms must establish that there is some normative value to the political salience of the current property tax system, a system that has been largely unchanged since the nineteenth century. In particular, it is a system that in its design flouts what we know about taxpayer psychology in general and about what we know about taxpayers opting for including property tax payments with their mortgage.

Indeed, staying with the prima facie case a bit longer, the data suggests that voters particularly hate the property tax even as they seem to like what it is being spent on and how (i.e., they like local governments - relatively).[123] This mismatch between cost and benefit could just manifest confusion or the fact that everyone wants something for nothing, but it can also indicate that there is something about the property tax, perhaps its salience – and perhaps something else (such as the liquidity concerns it engenders) – that is inhibiting proper deliberation. The "proper" here just indicates that something has misfired in a political deliberation where the deliberators simultaneously attach relative praise to the benefit but not to the cost. It would be one thing if this were the case as to a large national benefit, such as national defense and a broad-based national tax,[124] but remember that, short of direct pay for service, the property tax is supposed to be as close to a direct payment for local services as possible.

And this points to a related prima facie indicator of broken local democratic deliberation, which is that voters at the state level have increasingly acted to prevent such local deliberation from occurring. Even proponents of the property tax as benefit tax concede that the tax revolts of the last decades have gone so far that in many cases the property

[123] Cabral & Hoxby, *supra* note _, at 21.
[124] And so the argument here is both the reverse of and the same as that of Mettler. SUZANNE METTLER, THE SUBMERGED STATE (2011). Mettler is concerned that too much of government spending is hidden in the tax code, including upside-down subsidies that majorities of voters would not approve of if they were made explicit (based on experimental evidence). Voters are also unaware of government programs administered through the tax code that they are benefiting from. Thus, in contrast to my argument, Mettler generally argues that these tax provisions should be revealed to voters, i.e., become more politically salient. In this section, in contrast, I defend withholding even if that might make the property tax less politically salient. However, we are both arguing for better political deliberation. I am arguing that, as to the property tax, which is not withheld, encouraging better deliberation requires a different strategy from that required for better deliberation on federal income tax expenditures.

tax cannot act as a benefit tax.[125] In particular, strict property tax limitation regimes prevent local voters from modulating the property tax as they would like.

These considerations all suggest that the current property tax architecture is not sacrosanct and the property tax might work better as a benefit tax if reformed in a manner that addressed reasonable voter concerns with insurance and liquidity.

b. Deeper Responses

Political salience refers to the salience of a tax instrument at the time of taking political action. Market salience refers to the salience of a tax instrument at the time of taking a market decision. Which kind of salience would these reforms impact? And which kind of salience is most important for the operation of local democracy?

These are vexing questions. At the heart of most efficiency arguments for a multiplicity of local governments is the prospect that taxpayers can "vote with their feet." This makes the moment of making a market decision – in particular buying a home – of particular importance as a political matter. If this market decision is what is crucial for local politics, then the reform proposals herein, including withholding, would seem to be neither here nor there. Potential buyers will receive disclosures about property taxes in any event, and it is hard to understand how withholding will much change matters. And, even if withholding did reduce the market/political salience ("Tiebout Salience"?) of property taxes at the time of sale, Tiebout theorists have long claimed that there is a marginal homevoter, who, like the marginal consumer, can see through shrouding techniques and establish proper price points.[126]

In other words, to the argument that Tiebout competition is a fiction because homevoters understand neither local taxes nor local amenities in great detail, the argument is that there is a marginal homevoter, like the marginal consumer, who is setting the price for homes. Because this homevoter is responsive to the costs and benefits of a given jurisdiction's policies, the jurisdiction's government and other homevoters will receive feedback through this mechanism. As this homevoter is already working through all the disclosures about the property tax, and these reforms marginally impact these disclosures, there should be no net change to this so-called Tiebout Salience.

Now, the evidence for such marginal homevoters is equivocal and, accordingly, one may object that the whole model is descriptively inadequate. If there are local efficiencies to be had, one might cogently insist, they are not wholly a result of a quasi-political moment of home purchase, but through the more traditionally political realm of monitoring of local government, voting on local initiatives (such as about zoning and taxes), voting for local representatives, even participating oneself. In other words, and going back to De Tocqueville, some of the economic gains are tied to local political action, to voice.[127]

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[125] See, e.g., Fischel, supra note __, at 98.
[126] See, e.g., Fischel, supra note __ at 60-61.
[127] ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970) (exit v. voice).

Reducing the political salience of property taxes then would seem to undermine the exercise of voice in contrast to Tieboutian exit.

The question now becomes what it is voters ought to be aware of at the moment of local political action. In particular in this context I would argue, following the prima facie evidence of a broken system adduced above, that, as a matter of political salience, property tax burdens are perceived as deceptively high – a "hypersalience" problem.[128] Again, local voters do not generally pay their other taxes (e.g., income, sales) or other similar bills in one lump sum (e.g., for private school tuition, mortgages, home alarms). In addition, and more specifically, homevoters are partially responding to risks that they need not protect themselves against at the ballot box. Consider again a special assessment: a homevoter may see the proposed project as worthwhile,[129] but be wary of the risk of having impaired liquidity. This is a risk that efficiently administered circuit breakers and deferral can insure against directly, thereby *enhancing* local democracy because voters can approve the projects they want.

3. Short Conclusion on Normative Concerns

The brief answer to concerns about political salience is that we do not know enough about political salience – and likely will never know enough – to mount a cogent objection to an otherwise sensible tax reform on salience grounds. In the case of the property tax, a tax that is still collected more or less as it was a century ago, salience concerns are particularly dubious. These reforms, which would protect homevoters from liquidity and insurance shocks, seem much more likely to enhance local political economy rather than undermine it.

B. Administrative Concerns

Should a state choose to adopt this proposal, many additional design questions await. Here is an initial list:

1. What about states without an income tax?
2. What about commuting taxpayers, who live in one state and work in another?
3. Who defines the income used to implement a circuit breaker for commuting taxpayers?

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[128] Lilian V. Faulhaber, The *Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 BOSTON UNIVERSITY LAW REVIEW 1307, 1317 (2012) ("Hypersalience thus refers to the quality of being overly – and erroneously – prominent."); cf. Schenk supra note __, at 289 (voters might prefer tax collection regimes that do not trigger their tax aversion). Furthermore, property taxes may be hypersalient because certain homevoters, say the elderly, either do not use or know about the means at their disposal to lower their local property tax price. Reback, supra note _, at 21. This observation suggests that the reforms advocated here should both aim to increase utilization of property tax relief provisions and make this relief more prominent.

[129] That the project might *not* be worthwhile is what the homevoter is supposed to protect herself against at the ballot box and through monitoring.

All of these challenges can be responded to specifically. For instance, as to the second challenge, the state of residence could require commuters to set up automatic property tax payments through their banks and the state could coordinate the size of any circuit breakers through the banks just as it would with an employer.

Yet it should be observed that a federal approach could be particularly appealing for all of these challenges.[130] Thus, the federal government could institute withholding for any state that so requested. Withholding at the federal level also deals with the issue of commuting. As for a national definition of income, that could be resolved in two steps. The federal government could withhold a simple amount requested by the states (say 1% of AV for all of California) and then apply a very simple circuit breaker (say 8% of federal taxable income).[131] The federal government would then remit the amount withheld monthly. There would then be an annual reconciliation through the state income tax system (or standalone property tax system in a state without an income tax).

VI. More on the Federal Role

A. Basics

It is the contention of this paper that a revived local property tax would improve allocational efficiency at the national level through two channels: no longer favoring the housing sector and encouraging more and better local projects. This alone should make the local property tax a matter of federal concern. Furthermore, as I have argued supra and at length elsewhere,[132] enhancing state and local revenue stability through supporting the property tax would be a wise federal policy. As just indicated, one way for the federal government to support the property tax would be to use the national income tax infrastructure to withhold property taxes. A further, and particularly appealing, possibility would be for the federal government to advance deferred property taxes to local governments. Since the federal government has the power to borrow, this would in effect create a significant automatic stabilizer, a major contribution to macroeconomic stability that is well within the brief of a central government in a federal system.

Of course, using the federal income tax to withhold local property taxes and/or lend money to local governments would likely arouse significant political opposition. There are less politically fraught possibilities.

Most obviously, the federal government could offer grants, a sort of “race to the top” for updating local property tax infrastructure, such as creating employer-state-local interfaces. An additional spur could be if the federal government allowed the deduction for the property tax to be an “above the line” deduction, as it was for 2008 and 2009.

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[130] Note that federal involvement is certainly not a magic bullet. For instance, how would states deal with the inheritance of property on which a large amount of property tax had been deferred? My proposal would be that the new owners would be required to pay off the deferral, though on a generous schedule, and these new owners would themselves be protected by circuit breakers.

[131] Thanks to Kirk Stark for this suggestion. Note that this could be implemented with minimal interface between the state and federal systems.

[132] Shanske, How Less Can be More, supra note__, at 426-29.

Privileging the property tax in this way is itself an additional way for the federal government to encourage greater use of the property tax.[133] Yet allowing the deduction above the line also makes it easier for the local property tax automatically to *reduce* federal withholding. This is because *all* property owning taxpayers would get to use an above the line deduction regardless of their total income or other deductions. Perhaps this additional benefit (reduced federal withholding) could only be made available in states that were withholding local property taxes. This makes sense because why should the federal government make this extra revenue available if the states will not use it to improve their revenue systems?

B. Banks and a Federal Alternative

As noted above, banks offer tax escrow and these escrows, and other aspects of real estate practice, have long been subject to federal law, particularly the Real Estate Settlement Procedures Act of 1974 (RESPA). RESPA and the Truth in Lending Act (TILA) were recently amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), including as to tax escrow. Put simply, lenders are now *required* to provide escrow services on certain higher priced (including subprime) loans for five years, among other requirements.[134]

As for loans that do not require escrow, Dodd Frank requires that "the creditor or servicer shall provide a timely and clearly written disclosure to the consumer that advises the consumer of the responsibilities of the consumer and implications for the consumer in the absence of any such account."[135] Accordingly, the Federal Reserve (then the responsible agency) hired a private firm to evaluate disclosure about escrow even for borrowers that were not required to have an escrow account; the study also evaluated disclosure to those who were required to have an escrow.[136] According to the study, "[a]fter reading the notices, all participants indicated that they would want an escrow account with their mortgage."[137]

In other words, consistent with the research and analysis adduced above, as well as with its own experience and investigation, the federal government is already convinced of the merit of a kind of property tax withholding as a form of consumer protection.[138] Given that it is thus convinced, it is unclear why the federal government should not act to protect all consumers.

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[133] Shanske, How Less Can be More, supra note__, at 448.
[134] 15 U.S.C.A. § 1639d, added by sections 1461 of Dodd Frank; see 76 FR 11598-01 (proposed § 226.45). This essentially codified an earlier FRB rulemaking. Braunstein Testimony 4. See 12 C.F.R. § 226.35.
[135] Dodd Frank § 1461, revising TILA § 129D; see also Braunstein Testimony 17.
[136] ICF Macro, *Summary of Findings: Design and Testing of Escrow Disclosures* (Jan. 28, 2011).
[137] Id. at iii.
[138] You may ask, what is the current status of the implementing regulations? Great question. Dodd Frank transferred authority over these regulations to the new Consumer Financial Protection Bureau (CFPB), and I believe that action is coming. Docket No. CFPB-2012-0028 at 36 ("The Bureau is in the process of finalizing a proposal issued by the [Federal Reserve] Board to implement provisions of the Dodd-Frank Act requiring certain escrow account disclosures and exempting from the higher-priced mortgage loan escrow requirement loans made by certain small creditors, among other provisions, pursuant to TILA section 129D as established by Dodd-Frank Act sections 1461 and 1462 (Escrows Rulemaking). 15 U.S.C. 1639d.").

Indeed, it seems reasonable to this observer for the federal government to require that escrowing banks coordinate with state and local property tax regimes that incorporate the other kinds of reforms I have advocated. That is, the banks could also be required to calculate the amount to be escrowed in the same manner as employers would be required to withhold. As it is, the federal regulations require not only regular payment of property taxes, but also the use of an installment method if a local government offers it at no additional cost.[139] Given that the banks already need not pay interest on escrows and can maintain a cushion, it does not seem unreasonable also to require that they pay local governments on an installment basis and correspond with state governments to ascertain property tax burdens more precisely (e.g., apply circuit breakers). Certainly the latter reform is consistent with consumer protection.

Thus, in the end, the federal government can provide powerful leverage and even a partial substitute to the reforms I am advocating. But it is an imperfect substitute, as states ultimately need to pass the liquidity and value protections I propose. Furthermore, tax escrow only aids those homeowners with a mortgage, which is a good complement to withholding from income, especially for commuters, but an imperfect substitute. One additional advantage of maintaining a role for tax escrow, indeed perhaps expanding it to those without a mortgage, is that it might defuse political opposition from banks.[140]

VII. Conclusion

The state and local revenue system is often compared to a three-legged stool composed of the income tax, the sales tax, and the property tax. It is then commonly observed that the legs have grown quite uneven, with the property tax in particular having shrunk under the bombardment of Proposition 13 and related measures. The decline in the property tax has, in part,[141] contributed to an increase in state revenue volatility. We cannot be certain if the reform package outlined in this article would do much, if anything, to change this situation. Yet it is striking that it is only the property tax that has not much benefited from a century of advances in tax administration, and this suggests that a modernized property tax would be a revived property tax.

It is also commonly observed that the federal income tax systematically privileges the housing sector, distorting our economy. The local property tax minimizes this distortion and thus a revived property tax would enhance national allocational efficiency.

Finally, the theory of optimal fiscal federalism maintains that it matters which tax base is assigned to which level of government. It is better for the operation of the whole federal system for local governments to be able to fund themselves by means of the property tax.

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[139] 12 CFR 1027.17(k)(3).

[140] The loose analogy here could be the treatment of insurance companies under the ACA.

[141] Design choices of state sales and income taxes also contribute mightily to the volatility – in particular both taxes have increasingly narrow bases.

It is thus possible that a single set of reforms – modernizing the property tax – could simultaneously improve state and local finances while also improving allocational efficiency between sectors of the economy and levels of government. Even if modernizing the property tax did not much advance all of these goals, it would have the more pedestrian, but non-trivial, benefit of reducing needless taxpayer anxiety.