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PROPERTY TAX REASSESSMENT: WHO NEEDS IT?

Stewart E. Sterk* and Mitchell L. Engler†

INTRODUCTION

As state and federal politicians compete to take credit for popular programs while avoiding responsibility for tax increases, local property taxes have assumed renewed importance in financing critical public services. Across the country, property taxes remain an important revenue source for local governments, providing a primary source of funding for public schools, for police and fire departments, and for sanitation services.1 With the proliferation of unfunded mandates from state and federal governments, local governments face increased pressure to boost property tax revenues.2

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1 See Judy Zelio, The Role of Property Taxes in State and Local Finance, 34 ST. TAX NOTES 43 (2004) (discussing the connection between property tax and fire and police protection, schools, and streets). In 2000, the property tax accounted for 72.1% of local tax revenue in the United States, with wide variation from state to state. Id. at 44.

2 See Edward A. Zelinsky, The Unsolved Problem of the Unfunded Mandate, 23 OHIO N.U. L. REV. 741, 744 (1997) ("When local taxes increase to provide mandated services . . . the average taxpayer (erroneously) places responsibility upon the local officeholders who levy the increased taxes, not upon the state or federal officials who have mandated local costs without providing full reimbursement."). Although the burdens unfunded mandates place on local officials are clear, scholars disagree about the efficiency of these mandates. Julie Roin, for instance, argues that local officials can protect themselves in the political process, mitigating any inefficiencies resulting from unfunded mandates. See Julie A. Roin, Reconceptualizing Unfunded Mandates and Other Regulations, 93 NW. U. L. REV. 351, 376 (1999) (arguing that local governments serve as effective intermediaries in the political process, generating a counterweight to interest group pressure that would otherwise exist with funded mandates). For a less sanguine perspective, see Edward A. Zelinsky, Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services, 46 VAND. L. REV. 1355, 1386 (1993) (cataloguing disabilities local officials face in conducting trench warfare against unfunded mandates).
The political problems engendered by the need to increase tax revenues can be, in many ways, more serious with the local property tax than with the income and sales taxes more prevalent at the federal and state level. Any rise in the general level of wages and prices generates increased income tax and sales tax revenue, without any need for politicians to enact a tax increase. By contrast, even in a period of rising prices, municipal officials can generate additional property tax revenue only by taking actions for which they can be held politically accountable: enacting an increase in property tax rates, or reassessing property to increase the tax base.

When municipal officials seek more revenue, which of these two actions should they take? So long as the value of all property within the taxing entity changes in lockstep, taxpayers will face the same economic effect whether the municipality enacts a rate increase or, by reassessing property, enacts a commensurate increase in the tax base. Property values, however, do not change in lockstep. As a result, reassessment of property has the potential to change significantly the distribution of the municipality’s tax burden. It is that fact that makes reassessment a political hot potato.

Advocates of reassessment typically emphasize a fairness concern based on horizontal equity: properties of equal value should bear equal tax burdens. Opponents of reassessment focus instead on the dislocations that result from significant and unanticipated changes in tax burden, and in particular on the liquidity difficulties that reassessment generates for long-term residents of the community, who might have purchased their homes when values, and hence taxes, were far lower.

3 At the same time, property taxes are less subject to fluctuation in times of significant economic downturn, such as the one that occurred at the beginning of the twenty-first century. See Zelio, supra note 1, at 44.


6 The California Supreme Court summarized this position in sustaining Proposition 13 against constitutional attack, indicating that a property tax based on acquisition price “may be said reasonably to reflect the price [a landowner] was originally willing and able to pay for his property, rather than an inflated value fixed, after acquisition, in part on the basis of sales to third parties over which sales he can exercise no control.” Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization, 583 P.2d 1281, 1293 (Cal. 1978); see also Edward A. Zelinsky, The Once and Future Property Tax: A Dialogue with My Younger Self, 23 CARDOZO L. REV. 2199, 2202 (2002) (stating that rising property values can absorb large percentages of retirees’ incomes).
The debate over reassessment has generated no consensus. Many states have enacted statutes requiring periodic reassessment of real property, although practices in those states do not always conform to the statutory requirements. Other states, by contrast, have moved in the opposite direction, prohibiting reassessment for as long as a particular owner owns his or her home.

To date, however, the reassessment debate has largely ignored three critical issues. First, the debate has assumed that property taxes are ultimately borne by the person with the legal obligation to pay the tax. Economic theory, however, rejects this conclusion, suggesting instead that the economic incidence of taxes often differs substantially from legal incidence. With respect to property taxes in particular, economic theory predicts that at least some portion of tax differentials will be capitalized into home price, reducing any unfairness associated with assessments that depart from market value.

Second, proponents of periodic reassessment implicitly assume that property value is an objective fact, readily discernible by experts who observe the subject property. In fact, however, expert appraisals are costly and unreliable proxies for the value assessment seeks to capture: the price a willing buyer would pay a willing seller. Because reassessments will not accurately and cheaply capture market value, the fairness case for periodic reassessments is significantly overstated.

The debate has also ignored a third critical issue: the connection between local tax burdens and local service benefits. When that link becomes too attenuated, voter-taxpayers become more likely to vote for inefficient packages of municipal services. That is, a taxpayer

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7 See, e.g., Carin Rubenstein, An Especially Taxing Burden, N.Y. Times, Nov. 16, 2003, § 14WC, at 1 (quoting experts arguing that reassessments are needed “so that owners of similar houses get similar tax bills, meaning that recipients of services share the burden equally”).


9 Indeed, some go further and suggest that inspection may be unnecessary to determine value. See David M. Herszenhorn, A Path to Fairer Property Taxes, Where Politicians Fear To Tread, N.Y. Times, Oct. 9, 2000, at B1 (contending that “computers and mass appraising techniques now make it possible to conduct fairly accurate revaluations without the cost of hiring inspectors,” but noting also the view of critics who caution that statistical estimates are no substitute for physical inspections).

10 See generally Lee Anne Fennell, Homes Rule, 112 Yale L.J. 617, 622-23 (2002) (reviewing William A. Fischel, The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies (2001)) (discussing (although not ultimately endorsing) the view that in the local government market, separating tax burdens from tax benefits would generate “the same disastrous results we might expect to find in a private setting”).
whose tax assessment is low compared to the benefits she receives from additional municipal services will tend to support additional services even when the costs of those services greatly exceed their benefit; taxpayers burdened by high assessments will tend to oppose additional services even when those services generate more benefit than cost. One would expect, then, that municipal decisions will become more efficient as each taxpayer's share of the tax burden approaches her proportionate share of municipal benefits.¹¹ To the extent that municipal benefits are related to property value, efficiency concerns also support an alignment between property taxes and property value.¹²

How, then, can property tax law encourage efficient decisionmaking and improve tax fairness while avoiding the costs, inaccuracy, and liquidity difficulties associated with frequent reassessment? We propose that property be reassessed only upon sale, subject to a retrospective tax adjustment, payable by the seller, to compensate for the seller's low purchase price assessment during the seller's period of ownership. In its simplest form, taxes for each ownership year would be recalculated at sale by averaging the homeowner's purchase and sales prices. This provides a middle ground between a pure acquisition cost system, like California's Proposition 13,¹³ and a regime of periodic and costly reassessments. Part I surveys current law's diverse approaches to property reassessment. Part II develops and evaluates the horizontal equity case for frequent reassessment, demonstrating that the equity arguments are generally overstated, but that moral hazard problems arise when assessments deviate significantly from tax benefits. Part III establishes that the practical problems associated with any reassessment scheme undermine many of the purported ad-

¹¹ Another approach to potential inefficiencies in the voting process would connect voting rights to tax burdens. Thus, some states have authorized special purpose districts that permit only property owners to vote, and in some cases, that allocate voting rights in proportion to assessed valuation. See generally Richard Briffault, Who Rules at Home?: One Person/One Vote and Local Governments, 60 U. CHI. L. REV. 339, 365-66 (1993) (discussing the historical developments of the proprietary model of local governance). The United States Supreme Court, however, has foreclosed this option for most local governments, and for local school districts. Kramer v. Union Free Sch. Dist., 395 U.S. 621 (1969) (applying one-person/one-vote requirements to school districts); Avery v. Midland County, 390 U.S. 474 (1968) (applying one-person/one-vote requirements to local governments). See generally Briffault, supra, at 345-59 (discussing the Supreme Court's extension of the one-person/one-vote structure to local governance and school districts).

¹² When property taxes correlate poorly with property value, inefficient decisions to sell (or to hold) property may result. See infra Part IV.B.1.c.

¹³ CAL. CONST. art. XIIIa.
vantages of frequent reassessment. Part IV develops our reform proposal, demonstrating its significant advantages over all current approaches.

I. THE STATUS QUO: EXISTING PROPERTY TAX REGIMES

Although local governments typically collect and expend most property taxes, state constitutions and statutes provide the regulatory framework under which municipalities operate. In particular, many state constitutions provide that property shall be taxed in proportion to its value. In other states, legislation requires assessment at full value or a uniform percentage of value. Many states qualify the proportionality requirement by permitting municipalities to tax different classes of property at different rates; residential property, for instance, might be taxed at a different percentage of value than commercial property. And, of course, most states authorize a variety of exemptions from property taxation.

Value serves as the foundation for the property tax in virtually every jurisdiction, but states differ radically in how, and how often, they determine the value of real property. Some states do not impose any requirement on municipalities to conduct wholesale revaluations of property within municipal borders. In these states, many municipalities retain historic assessments for decades; an individual property is reassessed only if the property owner mounts a successful challenge to her own assessment.

14 Indeed, one commentator has noted that "state governments and voters have imposed so many restrictions on local access to the [property] tax that it has become crippled beyond recognition." Therese J. McGuire, Alternatives to Property Taxation for Local Government, in Property Taxation and Local Government Finance 300, 308 (Wallace E. Oates ed., 2001).
15 See, e.g., ILL. CONST. art. IX, § 4(a) ("Except as otherwise provided in this Section, taxes upon real property shall be levied uniformly by valuation . . . ."); N.J. CONST. art. VIII, § 1 ("All real property assessed and taxed locally or by the State . . . shall be assessed according to the same standard of value, except as otherwise permitted herein . . . ."); TEX. CONST. art. VIII, § 1(b) ("All real property . . . shall be taxed in proportion to its value . . . .").
16 See, e.g., N.Y. REAL PROP. TAX LAW § 305(2) (McKinney 2000) ("All real property in each assessing unit shall be assessed at a uniform percentage of value . . . ."); VA. CODE ANN. § 58.1-3201 (2004) ("All general reassessments or 'annual' assessments in those localities which have annual assessments of real estate . . . shall be made at 100 percent fair market value . . . .").
17 See, e.g., ILL. CONST. art. IX, § 4(b) (permitting counties with a population of more than two hundred thousand to classify real property for tax purposes); N.Y. REAL PROP. TAX LAW § 305(2) (permitting cities with a population greater than one million to adopt "classified assessment standard[s]").
New York provides an example. State legislation provides municipalities with some incentives to reassess property, but imposes no duty to do so. An individual landowner may challenge an assessment either on the ground that the assessment exceeds market value, or that the assessment is at a higher proportion of market value than other parcels on the assessment roll. These standards erect significant barriers for an ordinary homeowner; so long as the assessments are based on values set in the distant past, few valuations are likely to exceed market value. Because homeowners have limited ability to evaluate relative values of other homes in the area, proving that their assessments are disproportionate becomes difficult. As a result, a municipality that chooses not to update old assessments is likely to face challenges largely from commercial owners with the resources to compile the data necessary to mount a successful challenge. And it is the rare assessing unit that chooses to engage in wholesale revaluation. The result is assessments that often bear little relationship to current market values.

Other states, of which California is the most notable, require reassessment of real property upon sale, and then essentially preclude re-

18 N.Y. REAL PROP. TAX LAW § 524(2) (permitting challenges where assessment is excessive); id. § 701(4) (defining an excessive assessment as one "which exceeds the full value of real property").

19 Id. § 524(2) (permitting challenges where the assessment is unequal); id. § 701(8) (defining an unequal assessment as one "which is made at a higher proportionate valuation than the assessed valuation of other real property on the same roll").

20 Indeed, it is New York's statutory response to challenges by commercial owners that provides the impetus for the few wholesale revaluations that do occur. Successful commercial challenges to existing assessments can require payment of large refunds by taxing units. For instance, before a 2002 revaluation, New York's Nassau County faced an annual bill for tax refunds that exceeded one hundred million dollars, most resulting from challenges by large commercial owners. Vivian S. Toy, Nassau Again Faces Tax Refund Backlog, N.Y. TIMES, June 20, 2004, § 14LI, at 2; see also Debra West, Feud Erupts in Rye, in Print and in Public, N.Y. TIMES, Dec. 21, 2003, § 14WC, at 5 (noting that the Town of Rye began a revaluation project in response to payment of eighteen million dollars in tax reimbursements over a ten-year period).

21 Consider the following description of the assessment situation in suburban Westchester County:

The only Westchester town to have updated its tax assessment system is Pelham, which now has annual revaluations; in addition, the Town of Rye is in the process of conducting a town-wide reassessment. Every other Westchester municipality, however, is taxing homeowners based on assessments that are, on average, 38 years old, and thus reflect and preserve quirky and even inequitable judgments. That excludes Mount Vernon, with an assessment roll that is literally an antique, dating all the way back to 1853, according to Anthony DeBellis, the commissioner of assessment.

Rubenstein, supra note 7.
assessments until resale.\textsuperscript{22} The California assessment scheme, enacted as one component of Proposition 13's move for property tax relief, permits assessment changes to reflect the consumer price index (but not to exceed two percent per year);\textsuperscript{23} more significant changes in assessment are postponed until title is transferred to a new owner.\textsuperscript{24}

The California scheme has been heavily criticized for preferring existing homeowners over new residents,\textsuperscript{25} but the United States Supreme Court has rejected a constitutional attack on this discrimination,\textsuperscript{26} and other states have incorporated versions of the California statute into their own reassessment schemes. Florida, for instance, now provides for reassessment upon sale, with a three percent limit on subsequent reassessments until a later sale.\textsuperscript{27} Although California and Florida both provide for reassessment upon sale, neither relies on the sale price as conclusive evidence of value; California creates a rebuttable presumption that the sale price equals fair market value,\textsuperscript{28} while Florida anticipates that the property will be evaluated by professional appraisers or assessors.\textsuperscript{29}

\textsuperscript{22} See Cal. Const. art. XIII A, § 2(a).
\textsuperscript{26} Nordlinger v. Hahn, 505 U.S. 1, 10–18 (1992).
\textsuperscript{28} Cal. Rev. & Tax. Code § 110(b).
\textsuperscript{29} The Florida statute formally requires reassessment each year, and physical inspection of the property every three years. Fla. Stat. Ann. § 193.023 (West 1999). Once the appraiser reassesses the property, the homeowner's taxes are based on the lesser of the reassessment and the homeowner's original assessment augmented by the increase in the consumer price index, not to exceed three percent per year. Id. § 193.155(1) (West Supp. 2005).

Michigan does not even indulge in the presumption that the sale price reflects fair market value. Mich. Comp. Laws Ann. § 211.27(5) ("Beginning December 31,
A third group of states takes a completely different approach, requiring periodic and frequent reassessments in an effort to ensure a close connection between assessed value and current market value.\textsuperscript{30} Recognizing the heavy burden associated with frequent physical inspections for the purposes of appraising value and the allure of new technology, these states do not always require physical inspection each time reassessment is required. In Connecticut, for instance, the statute requires physical inspection every ten years, although revaluation of some sort is required every five years.\textsuperscript{31}

In some states, the push for frequent reassessment has been fueled in part by the notion that computerization can facilitate accurate assessments at far less cost and with far greater accuracy than traditional assessment methods.\textsuperscript{32} That notion, however, ignores the fact that no computer model can be any better than the data and assumptions used in developing the model.\textsuperscript{33} And accumulating the data requires the same fieldwork and judgment that has always accompanied the assessment process.

Statutory schemes that require frequent reassessment have generated yet another problem: long-term homeowners, especially retirees and others on fixed incomes, often face liquidity problems when tax assessments, and consequently tax bills, increase significantly to reflect changes in market value. In response, states often enact statutory provisions—generally known as circuit breakers—to protect certain classes of homeowners from the full impact of reassessments.\textsuperscript{34}

\begin{itemize}
\item \textsuperscript{30} See, e.g., CONN. GEN. STAT. ANN. § 12-62(b) (West Supp. 2005) (requiring reassessment every fifth year); TEX. TAX CODE ANN. § 25.18(b) (Vernon 2001) (requiring appraisal offices to provide for reappraisal of all property at least once every three years); VA. CODE ANN. §§ 58.1-3250 to -3261 (2004) (specifying reassessment cycles for various types of municipalities).
\item \textsuperscript{31} Compare CONN. GEN. STAT. ANN. § 12-62(a)(3) (requiring physical inspection every ten years), with id. § 12-62(b) (requiring revaluation every five years).
\item \textsuperscript{32} For an early endorsement of increased computer use, see Charles C. Cook, Computers in Local Property-Tax Administration, in THE PROPERTY TAX AND LOCAL FINANCE, supra note 8, at 95, 105–06.
\item \textsuperscript{33} Cf. Edward A. Zelinsky, For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues, 19 CARDOZO L. REV. 861, 881–82 (1997) (arguing that adjudications of real property values are unreliable because property owners have no incentive to reveal what they believe their property is worth).
\item \textsuperscript{34} See generally Steven D. Gold, Circuit-Breakers and Other Relief Measures, in THE PROPERTY TAX AND LOCAL FINANCE, supra note 8, at 148 (discussing proliferation of state property tax relief programs for homeowners in the latter half of the twentieth century).
\end{itemize}
state. Alternatively, states may offer deferral programs that permit homeowners to postpone payment of tax until death or transfer of the property. These programs—rarely used by homeowners—permit some homeowners with liquidity difficulties to retain their homes even when they cannot pay current taxes.

To summarize, then, state law reflects at least three different patterns with respect to property tax assessment. The first two—no reassessment and cost reassessment at sale—have been heavily criticized for unfairness because of their significant reliance on outdated market values. In contrast, the third—frequent reassessment even absent sales—involves significant municipal costs, and requires some mechanism for dealing with long-term homeowners who are unable, or feel unable, to afford significant tax increases attributable to new assessments. In the next Part, we confront the equity case for frequent reassessments.

II. THE CASE FOR FREQUENT REASSESSMENTS: HORIZONTAL EQUITY, PERCEPTION, AND ALLOCATIONAL EFFICIENCY

The basic argument for frequent reassessment of property is rooted in horizontal equity concerns: like taxpayers should be treated alike. Because the property tax is a tax on property value, properties of equal value should bear equal tax burden. The obvious analogy is

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35 Examples of circuit-breaker programs include those codified in CONN. GEN. STAT. ANN. § 12-170aa; GA. CODE ANN. §§ 48-5-47.1 (1999); and MICH. COMP. LAWS ANN. § 211.7u (West 2003).

36 These deferral programs are not necessarily tied to reassessment, but they nevertheless ease liquidity problems senior citizens would face upon reassessment. Sometimes the programs permit deferral even when taxes have not increased. See, e.g., 320 ILL. COMP. STAT. ANN. 30/3 (West 2001). In other states, deferral is available only for increased taxes. See, e.g., TENN. CODE ANN. § 7-64-201(a) (1998); see also Adrienne Blum, You Could Get a Break on Property Taxes, Kiplinger's Pers. Fin. Mag., Aug. 1992, at 83, 83 (listing states which provide deferral option along with qualifications).

37 One survey concludes that one out of seventy-two eligible households makes use of deferral options. David Baer, Awareness and Popularity of Property Tax Relief Programs, 5 ASSESSMENT J. 47, 53 (1998). For possible reasons explaining such limited use, see Joan Youngman, The Hardest Challenge for Value-Based Property Taxes: Part I, 16 ST. TAX NOTES 745, 747 (1999) (asserting that deferral programs are "notoriously underutilized" due to high state charges for deferral, lack of awareness of the programs, and reluctance to have liens placed on the property).

38 See, e.g., Robinson, supra note 25, at 528 (arguing that the use of acquisition value rather than fair market value makes it impossible for "the taxing authority to deliberately treat similarly situated taxpayers in the same manner"); Carl Shoup, The Property Tax Versus Sales and Income Taxes, in THE PROPERTY TAX AND LOCAL FINANCE, supra note 8, at 31, 32 ("Equal treatment of equals under a tax law is universally accepted as desirable.").
to the income tax, where the premise that equal income should generate equal tax enjoys widespread support.\(^3\)

Property values, like other market values, change over time. Sometimes the changes are due simply to inflation. At other times, the changes are due to changes in interest rates, or in the relative desirability of alternative investments. And at still other times, the changes are due to factors peculiar to a particular neighborhood or to improvements of the particular property. The standard horizontal equity argument posits that property assessments should change to reflect these changes in value; if assessments remain the same while values change, like taxpayers receive disparate treatment.\(^4\)

Perception alone provides a reason for taking steps to ensure that property tax assessments track fair market value. No one likes taxes, but taxpayers generally feel more aggrieved by a tax with an apparent inequitable distribution of the burden.\(^4\) Equal value generates equal tax is, for many, an appealing equitable principle. Absent countervailing considerations, reassessment to assure that property taxes remain proportional to fair market value appears to be a sensible starting point.

The horizontal equity argument for frequent reassessments, however, rests not simply on perception, but also on at least two unexplored premises. First, the horizontal equity argument assumes that current market value should be the appropriate basis for the property

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39 See, e.g., Richard D. Hobbet, Transitional Mechanisms To Facilitate Tax Reform, 34 LAW & CONTEMP. PROBS. 818, 821–22 (1969) (noting that while disagreements arise over the reach of income, "[i]t is relatively easy to find agreement for the statement that taxpayers having equal amounts of income should pay equal amounts of tax"); see also Michael Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. PA. L. REV. 47, 79 (1977) ("Perhaps the most widely accepted notion of fairness in taxation is the concept of horizontal equity. . . . [While determination of similarly-situated taxpayers is] fraught with ethical and theoretical difficulties . . . the basic notion of horizontal equity—equal treatment of equals—is widely shared and easily understood."). Some scholars question the significance of horizontal equity as an independent norm. See, e.g., Paul R. McDaniel & James R. Repetti, Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange, 1 FLA. TAX REV. 607 (1993).

40 The argument is often advanced by appraisers, whose professional livelihood depends in some measure on frequent updating of market value. See, e.g., INT’L ASS’N OF ASSESSING OFFICERS, PROPERTY APPRAISAL AND ASSESSMENT ADMINISTRATION 3 (Joseph K. Eckert et al. eds., 1990) ("Appraised values used for tax purposes must be accurate so that the tax burden will be distributed fairly.").

41 HARVEY S. ROSEN, PUBLIC FINANCE 529 (7th ed. 2005) ("To the extent that [the property tax] valuation is done incompetently (or corruptly), the tax is perceived as unfair."); see also id. at 309 (noting that the perceived unfairness of a new tax based on where an individual lived was one factor that led to Prime Minister Margaret Thatcher’s downfall in 1990).
tax. That assumption, however, raises questions about the underlying justifications for a property tax. Second, the horizontal equity argument assumes that the property tax burden shouldered by each individual property owner can be measured by, or is at least proportional to, the property tax formally assessed on the subject parcel. If the correlation is weaker, then the horizontal equity case for frequent reassessments is correspondingly weaker. This Part starts by examining these two questions: why a property tax, and who bears its burden? After concluding that capitalization of differential tax assessments weakens the horizontal equity argument for frequent reassessments, this Part moves on to consider the moral hazard problem generated by tax assessments unrelated to market value, and concludes that arbitrary assessments are likely to generate inefficient taxing and spending decisions.

A. Justifications for a Property Tax

As with most taxes, the principal objective of the property tax is to raise revenue in an efficient and equitable manner. Why do municipalities use the property tax to raise revenue rather than the income and sales taxes more prevalent at the state and federal levels? In part, history provides an answer: the antecedents of the modern property tax long predate the sales and income taxes. Good reasons supported that historical preference. First, in an era before formalized, long-term employment relationships, tax withholding was impractical, making an income tax more complicated to administer than a prop-


44 See generally John Joseph Wallis, A History of the Property Tax in America, in Property Taxation and Local Government Finance, supra note 14, at 123 (discussing the historical development of the property tax in the United States).
Some of these reasons have become less persuasive in the modern era, but the property tax has endured, in part because states have not generally authorized municipalities to collect sales or income taxes. Moreover, it would not, in any event, be administratively feasible for most local governments to administer their own income or sales taxes; to reduce administrative costs, those taxes would have to "piggyback" on state collections. And state officials might prefer to divorce themselves from any association with local taxes. From their

45 See Robert Inman, Commentary, in Property Taxation and Local Government Finance, supra note 14, at 148, 150 (noting that before 1900, informal economy was large and "record-keeping for most small businesses was idiosyncratic to nonexistent," making the property tax, administratively, a lower-cost tax than the sales tax or the income tax).

46 No less an economist than Adam Smith recognized that house rents represented a good proxy for wealth. 2 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 369 (Edwin Cannan ed., Univ. of Chi. Press 1976) (1776). House rents, however, were not publicly reported, raising evasion opportunities. Smith recounted the various English attempts to tax indicia of house rents—first hearths and then windows—that made evasion more difficult. Id. at 369-73. For further discussion, see Deborah L. Paul, The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?, 76 N.C. L. Rev. 151, 165-66 (1997).

47 Tax foreclosure sales do impose administrative burdens on municipal officials, and federal constitutional requirements increase those burdens, at least to some degree. Cf. Mennonite Bd. of Missions v. Adams, 462 U.S. 791, 798-800 (1983) (holding that due process requires notice by mail or other means certain to ensure actual notice when the municipal official knows or can obtain knowledge of the address of the person entitled to notice). In recent years, some municipalities have sold tax liens to private parties, avoiding many of these burdens. See Frank S. Alexander, Tax Liens, Tax Sales, and Due Process, 75 Ind. L.J. 747, 760-63 (2000). Indeed, private collection of taxes can be traced to Roman times. Id. at 758.

48 States might reasonably be concerned that, left unconstrained by state law, municipalities would choose to impose taxes that fall most heavily on outsiders. As one scholar has put it, "[g]iven a choice of tax instruments, the welfare-maximizing local decisionmaker should be expected to make maximum use of exportable taxes." Stark, supra note 43, at 221. From the perspective of state legislators, such taxes may be unattractive, either because the tax undermines the accountability of government, id., or because the tax will be politically unpopular with constituents from neighboring municipalities. As Stark points out, however, even if a municipality imposes a tax that falls initially on outsiders (such as a sales tax on a shopping center near the municipal border), local residents may nevertheless bear the ultimate burden of the tax as outsiders relocate their economic activities. Id. at 223.

perspective, it is far better for local officials to shoulder responsibility for local taxes.\textsuperscript{50}

Although history and politics play a substantial role in explaining the persistence of the property tax, the tax is not without enduring justifications. The property tax retains some aspects of a tax on benefits conferred, and also some aspects of a tax based on ability to pay.\textsuperscript{51}

1. The Property Tax as a Benefits Tax

In a broad sense, any tax is a benefits tax; any governmental entity seeks to tax those who benefit from government services, and generally to exclude from benefits those who pay no tax.\textsuperscript{52} Local property taxes certainly fit that pattern.\textsuperscript{53} Indeed, with respect to residential suburbs and small towns and cities, the property tax has been characterized as "the dues one pays voluntarily to gain access to the services and facilities the club offers."\textsuperscript{54} Those who want the benefits conferred by a particular municipality choose to buy homes in that municipality, knowing that the municipality's property taxes are the price

\textsuperscript{50} See McGuire, supra note 14, at 309 (noting the propensity of state politicians to place restrictions on local taxes, taking credit for the tax reduction without having to bear the costs themselves).

\textsuperscript{51} Including the property tax in a tax system that also relies on sales and income taxes generates another benefit: diversification, which reduces the impact of defects in any particular tax. See generally Robert J. Cline & John Shannon, The Property Tax in a Model State-Local Revenue System, in The Property Tax and Local Finance, supra note 8, at 42, 46–47 (discussing "several real virtues" of the property tax when used in moderation by local governments).

\textsuperscript{52} Wallis, supra note 44, at 125 ("All governments would like to levy benefit taxes—taxes paid by the people who benefit directly from the government services the taxes finance—but local governments are consistently able to do so."). There are limited exceptions, such as the income tax exemption for low-income taxpayers. See I.R.C. §§ 1, 63(b) (2000).

\textsuperscript{53} See Wallis, supra note 44, at 141 ("The property tax can operate as a benefit tax only if the government spends money on services that are geographically specific."); id. at 145 (concluding that local governments, but not states, can use the benefit features of the property tax to match taxpayers and beneficiaries).

\textsuperscript{54} Dick Netzer, Local Property Taxation in Theory and Practice: Some Reflections, in Property Taxation and Local Government Finance, supra note 14, at 321, 328. The benefits view is less compelling with regard to large cities. See id. at 325–27; see also George R. Zodrow, Reflections on the New View and the Benefit View of the Property Tax, in Property Taxation and Local Government Finance, supra note 14, at 79, 93 & n.23 (noting that the descriptive force of the benefits theory varies with the context). The benefits view also loses force regarding property taxes paid by businesses. See, e.g., Thomas J. Nechyba, The Benefit View and the New View: Where Do We Stand, Twenty-Five Years into the Debate?, in Property Taxation and Local Government Finance, supra note 14, at 113, 117.
for those benefits. Indeed, property taxation and the attendant benefits provide the basis for Tiebout-style competition among municipalities that transforms public goods into private goods and leads to more efficient production and distribution of those goods. By contrast, the base for the income and sales tax may be more mobile than the property tax base, increasing the opportunity for individuals to avoid the tax while accepting municipal benefits, thus reducing the likelihood of efficient production of goods and services.

The argument so far has been that the aggregate level of property taxation imposed by any municipality is closely related to the benefits its residents, in the aggregate, derive from those taxes. The next question is whether the property tax reflects the relative benefits derived by individual residents of the municipality. With respect to some municipal services—fire and police protection, for example—the answer is probably yes. Residents whose homes are more valuable derive more benefit from municipal services designed to protect persons and property. But outside of major cities, the most expensive service financed by the property tax is public education. And the connection


56 See generally Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. POL. ECON. 416, 418–23 (1956) (discussing the ways in which public expenditures at the local level, unlike at the federal level, can be made more efficient by resembling an open market).

57 See McGuire, supra note 14, at 310 (“Individuals can avoid sales and income taxes by shopping and working ... in neighboring jurisdictions, whereas the property tax is unavoidable.”); see also Steven M. Sheffrin, Commentary, in PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE, supra note 14, at 315, 317–18 (noting avoidance difficulties that would be generated by using sales and income taxes at the local level); Joel M. Stern, Optimality and Property Taxation: An Alternative Approach, in THE PROPERTY TAX AND LOCAL FINANCE, supra note 8, at 204, 204 (“In contrast to income that can be transferred geographically to other jurisdictions, property can be taxed locally for local government.”).

58 By one estimate, eighty percent of all local property tax revenues might be conceived as benefit taxes. Netzer, supra note 54, at 333.

59 Cf. Kaplow, supra note 55, at 427 (“[T] hose who have more luxurious houses may benefit more from police protection and road quality.”).

60 One estimate, based on data from the 1992 Census of Governments, concludes that about 52% of local government property tax revenue, nationwide, is devoted to education financing. Netzer, supra note 54, at 331.
between property value and benefits derived from public education is somewhat more tenuous.\textsuperscript{61}

The benefits derived from a municipality's maintenance of its school system are twofold.\textsuperscript{62} First, the students educated in the system (and their parents) benefit directly from the public education they receive. A tax based on property value correlates poorly to this benefit; children of parents who own small houses receive the same education as children of parents with expensive houses.\textsuperscript{63} But the right to use a school system, and especially a high quality school system, increases the value of property within the school district even if the current occupants make no use of that system.\textsuperscript{64} This second benefit correlates quite well with value of property within the municipality.

A well calibrated benefits tax would account for both of these benefits. A property tax based on current value of property does not. In at least two ways, a property tax that relies in part on historical value rather than current value may better capture the benefits generated by public schools. First, on average, the residents who benefit from public schools will be people who have purchased their homes more recently. Few homeowners will be deriving direct benefit from the public schools thirty years after their initial purchase; children are more likely to use schools during the early years of home ownership.\textsuperscript{65} Second, to the extent homeowners derive indirect benefit from schools through increased home values, that indirect benefit is not realized until sale; a property tax that deferred some of the tax obligation until sale would generally be more consistent with a benefits justi-

\textsuperscript{61} See Kaplow, supra note 55, at 423 ("[A] resident who lives in a mansion pays much greater property taxes than one who lives in a small house, yet they have access to the same schools . . . .").

\textsuperscript{62} For present purposes, we will exclude the external benefit conferred on the public at large when the citizenry is better educated.

\textsuperscript{63} Conversely, the elderly or others who do not use the public schools receive none of this benefit but may pay significant property taxes. Cf. Fennell, supra note 10, at 637–38 ("Families with children enrolled in the public school system typically consume far more . . . resources . . . than do families without children.").

\textsuperscript{64} Much of the local government literature has recognized that the benefits of municipal services are, to some extent, capitalized into home prices. The debate is over the degree of capitalization. The premise behind William Fischel's influential work is that capitalization is pervasive. William A. Fischel, The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies 47–51 (2001). Others, while conceding some capitalization, are more skeptical about its scope. See, e.g., Richard Schragger, Consuming Government, 101 Mich. L. Rev. 1824, 1830 (2003) (reviewing Fischel, supra).

\textsuperscript{65} See Jane J. Mansbridge, Beyond Adversary Democracy 95 (1983) (noting that in the New England town that served as the subject of study, newcomers had more school-aged children than long-term residents).
fication than a tax collected each year based on then-current market value.

Our objective in this section is not to present a rigorous case for any particular change in the property tax; we defer that objective until later in this Article. Instead, this section has been designed to show that if the property tax is conceived as a benefits tax, a focus on current market value as the tax base is not inevitable. Indeed, too much focus on current market value weakens the argument that property taxation constitutes a well tailored form of benefits taxation.

2. The Property Tax as an Ability-to-Pay Tax

In evaluating other broad-based taxes, particularly taxes on income and consumption, scholars typically focus not on whether the distribution of tax burdens mirrors the distribution of government benefits, but rather on whether the tax accurately captures taxpayers' relative ability to pay. This view not only acknowledges, but embraces, a separation between tax payments and benefits as a potential redistribution vehicle. Local taxes based on ability to pay, however, face a significant problem: taxpayer mobility. If a municipality seeks to impose too large a share of the cost of municipal services on wealthy taxpayers, those taxpayers will choose to locate in a municipality that more closely aligns taxes with benefits received. Competition among municipalities to attract taxpayers who will pay more in

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66 See, e.g., David Shakow & Reed Shuldiner, A Comprehensive Wealth Tax, 53 Tax L. REV. 499, 500 (2000) ("The classic equitable justification for the income tax is that a tax should be based on ability to pay and income is the best measure of ability to pay.").

67 See, e.g., Kaplow, supra note 55, at 472 & n.157 (citing authorities); see also infra Part II.C (discussing the moral hazard voting concern at the local level which thus provides a second impediment to local-level redistribution).

68 As Richard Briffault has observed: "Contemporary cities, as a rule, do not engage in innovative redistributive programs . . . because they fear that initiating such programs would cause residential and commercial taxpayers to depart." Richard Briffault, Our Localism: Part II—Localism and Legal Theory, 90 COLUM. L. REV. 346, 408 (1990).

Indeed, it is this fact that has led many reformers associated with the political left to advocate a greater role for state and regional governments in funding public education, reducing the ability of the wealthy to avoid redistribution by moving to municipalities without poor people and consequently without redistribution-based policies. See, e.g., Sheryll D. Cashin, Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism, 88 GEO. L.J. 1985 (2000); Gerald E. Frug, Beyond Regional Government, 115 HARV. L. REV. 1763 (2002); Schragger, supra note 64, at 1855 ("[O]ur current localism and the fiscal inequities that accompany it can only be tempered by some form of state- or regionwide input.").
taxes than they consume in services constrains municipal efforts to implement a tax system that focuses too heavily on ability to pay.69

Nevertheless, taxpayer mobility is far from perfect, leaving some room for municipalities to correlate local taxes with ability to pay. Because most Americans have no other asset as valuable as their home,70 a tax on the value of that home correlates to some degree with personal wealth which is, along with income, a significant component of ability to pay.71 For a variety of reasons, however, the correlation is rough at best.

First, the property tax is a tax on the total market value of the property, not a tax on the owner's equity. As a result, an owner with the resources to pay cash for a $300,000 home bears the same tax as an owner who has put $30,000 down and bears a $270,000 mortgage.72 Second, neither the market value nor the owner's equity in the property correlate particularly well with the liquidity necessary to pay current taxes.73 An owner who purchased a home for $100,000 fifteen years ago may—or may not—have resources comparable to a person who purchased an identical home recently for $300,000. Much depends on the relative rate of increase in personal income and real estate prices. If real estate has increased more rapidly than personal income, people who purchased fifteen years ago, on average, would

69 Cf. Kaplow, supra note 55, at 444 ("[T]he potential out-migration of the wealthy and in-migration of the poor may lead the jurisdiction to provide a mix of public goods and services that is more valuable to the wealthy."); Daniel L. Rubinfeld, The Economics of the Local Public Sector, in 2 HANDBOOK OF PUBLIC ECONOMICS 571, 630-31 (Alan J. Auerbach & Martin Feldstein eds., 1987) ("[L]ocal governments are likely to be most responsive to the variations in demands for public goods.").


71 See Shakow & Shuldiner, supra note 66, at 500 (noting that while income tax proponents often justify the income tax as the best measure of ability to pay, "[b]oth greater wealth and greater income clearly are correlated with greater ability to pay"); see also Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1167-68 (1992) (describing arguments supporting a consumption tax on ability-to-pay grounds); Robinson, supra note 25, at 521-22 ("[M]arket value has been generally viewed as a rough proxy for ability to pay.").


73 This discussion includes liquidity concerns under the ability-to-pay rubric. Alternatively, liquidity could be treated as a concern distinct from ability to pay. Compare William A. Klein et al., Federal Income Taxation 6 (13th ed. 2003) (stating that while a "narrow view" of ability to pay would consider liquidity, a "broader view... would look at people's material well-being without regard to liquidity"), with id. at 202 (recognizing liquidity as a valid concern for certain taxpayers).
not be able to purchase the same house today; if personal income has increased more rapidly than real estate prices, people who bought fifteen years ago, on average, have more available resources than more recent purchasers of comparable homes.

The point is that a property tax levied on current market value is one of several property taxes that would correlate positively with ability to pay. A tax on homeowner equity would have a positive correlation, as would a tax based on the homeowner's initial purchase price. The correlation between current market value and ability to pay might generally be closer than the correlation generated by the alternative tax bases, but no a priori principle dictates that result. And we know of no empirical studies that measure the relative correlation of these alternative tax bases with ability to pay.

B. Who Bears the Property Tax Burden: Capitalization of Tax Differentials

This Part started with a recitation of the basic argument for continuous reassessment of property to current market value: like cases should be treated alike; properties of equal value should bear equal tax burdens. Part II.A demonstrated, however, that what constitutes a like case is a question fraught with some difficulty. This subpart turns to a related question: who bears the property tax. In one sense, the answer is obvious: the owner of the subject property bears the legal obligation to pay the tax on that property. But the legal obligation to pay the tax is not the same as the economic incidence of the tax.74

Indeed, the economics literature has generated considerable debate over the ultimate incidence of the property tax.75 The "benefit view" holds that property taxes are fully capitalized into home values, so that property owners as a group bear the full brunt of the property tax.76 The "new view" (which appears to be nearly as old as the benefit view) argues instead that the property tax is ultimately a tax on

74 See generally Heilbrun, supra note 8 (distinguishing between legal and economic incidence and noting that evaluating economic incidence entails examining whether the person with the legal obligation can shift the burden of the tax to other persons).

75 See generally Clayton P. Gillette, Direct Democracy and Debt, 13 J. Contemp. Legal Issues 365, 392 (2004) (noting that the literature on the scope of capitalization of taxes is mixed but concluding that it is clear that "some level of capitalization occurs").

capital owners generally. But proponents of the new view argue only that the average or aggregate burden of the property tax falls on capital generally; they concede that local residents will bear the full burden of an increase in the property tax. Neither theory, however, focuses on the distribution of property tax burdens within a given municipality.

This subpart demonstrates first that within any municipality, even if tax assessments are entirely arbitrary but permanently fixed in amount, the differentials among comparable homes will largely be capitalized into house price, so that the overall housing costs of owners with low tax assessments will equal the overall costs of owners with high assessments. This subpart then considers the impact of assessments that are subject to change—either at periodic intervals or upon sale of the property.

1. Arbitrary but Fixed Assessments

Consider a municipality with a tax rate of one percent on the assessed value of all real property within its borders. Suppose that two comparable homes are assessed at grossly different values: one at $500,000 and the other at $300,000. Prospective purchasers understand that the tax on one home will be $5000, but the tax on the other home will be only $3000. Because the two homes are located in the same municipality, a prospective purchaser will receive the same benefits regardless of the home she purchases. That is, if she has three school-age children, she will receive the same schooling regardless of house. How would a prospective purchaser respond to the differential assessment? Economic theory (and common sense) predicts that she would pay significantly more for the home assessed at $300,000 than for the home assessed at $500,000. In rough, commonsense terms, even if the purchaser had to borrow more to purchase the low-assessment house, the borrowing would be worthwhile whenever the

77 The new view starts with the assumption that the overall national supply of capital is perfectly inelastic, and argues that any increase in the level of property taxation reduces the return to that capital, functioning in effect as a profits tax. See Peter Mieszkowski, The Property Tax: An Excise Tax or a Profits Tax?, 1 J. PUB. ECON. 73 (1972); Zodrow, supra note 54, at 81.

78 See Zodrow, supra note 54, at 105; see also Wallace E. Oates, Property Taxation and Local Government Finance: An Overview and Some Reflections, in PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE, supra note 14, at 21, 22 ([B]oth theories imply that the benefits and costs of local programs are borne locally . . . .).
additional money borrowed is more than offset by the tax savings generated by the low assessment.\(^7\)

The implications of this analysis are important. If 100% of the difference in tax burden is capitalized into the market price for the home, the purchaser of a low-assessment home pays precisely the same amount (in purchase price and taxes) for the combination of public and private benefits as does the purchaser of a high-assessment home. The market ultimately shifts some of the tax burden from the high-assessment owner to the low-assessment owner by increasing the purchase price the low-assessment owner must pay for her home.

Consider the implication of this insight on the “benefits tax” justification for the property tax. Because property taxes are capitalized into the property’s market value, the property tax functions as an effective benefits tax to the extent that municipal benefits are capitalized into property value. And, as we have seen, those benefits are partially, but not completely, capitalized.

Next, consider the implication of 100% capitalization of property taxes on an ability-to-pay justification for the tax. Because complete capitalization links the impact of the tax to the value of the property, the property tax becomes an ability-to-pay tax to the extent property value reflects ability to pay. That linkage between tax burden and ability to pay remains constant even as the formal tax base departs from actual market value. The basic point, then, is that so long as tax burdens are capitalized into market value, arbitrary tax assessments generate the same post-tax consequences to the homeowner—both from a benefits perspective and from an ability-to-pay perspective—as assessments that perfectly reflect market value.

2. Assessments Subject to Revision

The preceding section demonstrates that if prospective purchasers could be assured that their tax assessments would not change, one would expect close to 100% capitalization. That, in turn, would significantly undermine the horizontal equity case for frequent reassess-

\(^7\) In theory, the purchaser should be willing to pay an additional increment for the house with the low assessment that reflects the capitalized value of the prospective tax savings. Professor William Fischel has offered a concrete example in practice. He studied two adjacent municipalities in New Hampshire in which a single developer had constructed nearly identical homes across municipal boundaries. The two municipalities shared a high school. His study concluded that, even though the tax rate in one municipality was far higher than in the other, home prices in the low-tax municipality were sufficiently higher that home purchasers would face precisely the same monthly mortgage and tax payment whether they purchased in the low-tax or high-tax municipality total property. FISCHEL, supra note 64, at 40–42.
ments. How does the analysis change if the municipality sometimes alters tax assessments?

First, suppose the municipality reassesses all property at periodic intervals. If the periodic intervals are fixed in advance (e.g., reassessment every ten years), and if the reassessment generates a close approximation to market value, one would still expect close to 100% capitalization of tax costs. If a particular landowner's parcel is significantly underassessed or overassessed at some point during the periodic interval, the landowner knows that she will enjoy the benefit (or suffer the detriment) of the assessment until the property is reassessed at the close of the interval. Hence, the price a purchaser would pay should reflect, in large measure, the disparity between current assessment and market value.

If the periodic intervals are not fixed in advance, uncertainty about the duration of the disparity will prevent complete capitalization. Prospective purchasers will make purchasing decisions based on "guesstimates" about the duration of any tax benefit or detriment, but there is no assurance that those guesstimates will ultimately prove accurate. As a result, some purchasers will pay more, and others will pay less, than they would if assessments were all maintained precisely at fair market value. From a benefits perspective, this creates an imbal-

80 Even with capitalization, though, uneven assessments might raise vertical equity concerns due to the federal tax deduction of state property taxes. High-assessment homes therefore generally should gravitate towards high-bracket taxpayers. Uneven assessments therefore could alter federal tax liabilities relative to a system with even assessments. The analysis is complicated by the federal alternative minimum tax (AMT), which disallows the property tax deduction in certain cases. While this somewhat counteracts the vertical equity concern, it also complicates the decision whether to buy a high-tax or low-tax home. For a discussion of the AMT, see infra note 160.

81 Capitalization will not be complete unless the purchaser can anticipate prospective changes in the tax rate, changes which would have an obvious impact on the purchaser's tax burden. Of course, even if the purchaser cannot precisely anticipate changes in the tax rate, capitalization should be close to complete if the taxpayer were assured that unanticipated rate changes would generate commensurate changes in the benefits derived from municipal services. But as we demonstrate below, that assumption is heroic, especially as the connection between taxes and benefits diverges. See infra Part II.C.

82 Two competing factors will also operate to skew tax burdens away from the current market value norm. First, assuming prospective purchasers make a range of guesstimates about the duration of any tax benefit or detriment, the prospective purchasers who are most optimistic in their assessments—those who believe benefits will endure longest and detriments will end fastest—are most likely to become actual (rather than prospective) purchasers. Because of their optimistic guesstimates, they will pay more for the property than their pessimistic competitors. But because there is no a priori reason to believe that their estimates are more accurate than those of
ance if we assume that current market value generally reflects benefits received. From an ability-to-pay perspective, inaccurate guesstimates will also skew the total tax burden away from ability to pay, as measured by current market value of the property.

Next, suppose the municipality reassesses property upon sale, but not otherwise. Assuming a general increase in the market value of homes, a purchaser's assessment will be higher than the assessment of a neighbor who has owned an equivalent home for a number of years. This excess tax burden should be reflected in the price the purchaser pays for the home. At the same time, however, if the purchaser assumes future increases in property value, and assumes future sales of other homes within the municipality, the purchaser will recognize that her share of the tax burden will diminish over time. That realization, in turn, will increase the price the purchaser is willing to pay for the home as the purchaser capitalizes those future benefits. Nevertheless, various forms of uncertainty will prevent complete capitalization of the tax burden. First, there is little reason to believe that purchasers will guess accurately about the rate of future growth in purchase prices. Second, purchasers cannot know with precision the future rate of home sales within the municipality—data essential for estimating future tax burdens in a system that reassesses upon sale. Third, most purchasers do not know with certainty how long they will remain in the houses they purchase; because the houses will be reassessed upon subsequent sales, the purchasers cannot transfer the tax benefits associated with low assessments.

The basic insight is a simple one: uncertainty inhibits complete capitalization of tax burdens. The preceding section demonstrated that arbitrary but fixed tax assessments will be capitalized into home price. This section predicts that capitalization will remain close to complete if purchasers know precisely when reassessment will occur. But when the date of the next reassessment is uncertain, or when the homeowner's tax burden depends on the duration of her ownership and the duration of her neighbor's ownership, capitalization will be less than complete, and the distribution of tax burdens will deviate from the current market value benchmark.

their competitors, the likelihood is great that prospective purchasers of overvalued and undervalued properties will, over time, pay more in purchase price and taxes than purchasers of property valued at current market value.

Competing with this bias in favor of optimistic prospective purchasers, however, will be a tendency of homeowners generally to be risk-averse. This tendency will generally lead prospective purchasers to undervalue tax benefits and overvalue tax detriments resulting from unequal valuation. How these two factors will interact in practice is impossible to determine on any a priori basis.
Empirical work supports this conclusion. The principal study—conducted in the Boston area—proceeded against background legal principles that required assessment at 100% of fair market value. Against that background, it would be irrational for purchasers to capitalize 100% of the tax differential, because they faced a significant risk that reassessment would reduce that differential yet did not know when that risk would mature into an actual reassessment. The study, in fact, demonstrated only about 20% capitalization of the tax differences between comparable homes.83

When capitalization is incomplete, the economic incidence of the tax will, to some extent, track the formal legal burden of the tax. Two people owning comparable homes with differential assessments might bear different tax burdens.

What impact does incomplete capitalization of differential tax burdens have on the “benefits tax” justification for the property tax? If benefits derived from municipal services were completely capitalized into home price, then tax assessments that deviate from current market value would weaken the link between taxes and benefits. But, as we have seen, tax benefits are not completely capitalized into market value, so the ultimate impact on the benefits justification remains uncertain. If the disparities in tax assessments mirror the uncapitalized benefits of municipal services—as they might in a system where long-term residents enjoy lower assessments—ineffective capitalization might even bring tax burdens into greater congruence with municipal benefits. If, however, there is no connection between assessment disparities and uncapitalized benefits, assessments based on current market value would generally be more consistent with the benefits tax justification.

It is similarly difficult to assess the impact of incomplete capitalization of differential burdens on the ability-to-pay justification for the property tax. If market value of the property is a good surrogate for ability to pay, then in a world of incomplete capitalization, differential tax assessments for comparable properties will lead to tax results that deviate from ability to pay. If, however, historic value also captures some elements of ability to pay, incompletely capitalized tax differentials might be consistent with the ability-to-pay justification—so long as the tax disparities were related to historic value.

C. Arbitrary Assessments and the Moral Hazard Problem

The preceding subpart demonstrates that the horizontal equity case for assessments based on current market value is an equivocal one. Public perception aside, even assessments that bear little relation to current market value generate no horizontal inequities so long as those assessments, and the taxes based on the assessments, are fixed. When assessments (and the resulting taxes) are subject to change, uncertainty about the timing of the change increases the likelihood that the ultimate tax burden will not be proportional to the current market value of the property. How much horizontal inequity this disproportion generates depends on how good a proxy current market value is for benefit on the one hand, or ability to pay on the other.

The discussion so far has ignored tax rates. The assumption has been that tax rates are fixed. Tax rates, however, are not constant. Rates (and overall tax collections) are set by political processes. Typically, voters or their representatives approve local tax rates.84 This political involvement in the rate-setting process introduces moral hazard problems that are exacerbated when the tax base is arbitrary.

Modeling political behavior is fraught with peril. Two difficulties predominate. First, what motivates voters? Do they vote out of self-interest, as the public choice literature typically assumes,85 or are they motivated more broadly based on ideology, altruism, or other concerns not directly related to self-interest?86 Second, do elected officials act as faithful agents, effectively representing the preferences of

84 Cf. Stark, supra note 43, at 203–05 (discussing state reforms increasing the right of taxpayers to vote on taxes).

85 A common public choice assumption is that in the political arena, as in the economic arena, “people will allocate their limited means...to maximize their personal satisfaction.” Michael E. DeBow & Dwight R. Lee, Understanding (and Misunderstanding) Public Choice: A Response to Farber and Frickey, 66 Tex. L. Rev. 993, 996 (1988); see also James M. Buchanan & Gordon Tullock, The Calculus of Consent 19–20 (1962) (noting the assumption that individuals act on the basis of the same overall value scale when they participate in political and market activity).

A common critique of the public choice model is that it does not adequately explain why voters vote at all, given the small likelihood that any individual result will affect a collective decision. See, e.g., Daniel A. Farber & Philip P. Frickey, Public Choice Revisited, 96 Mich. L. Rev. 1715, 1719 (1998). This critique, of course, becomes less persuasive as the size of the group declines, as it does with respect to local governments, at least in small municipalities.

However significant these modeling difficulties may be at the state or federal level, it seems plausible to assume that at the local level, at least in those municipalities dominated by homeowners, self-interest plays a dominant role in voter behavior. As William Fischel has emphasized, homeowners typically have more equity in their homes than in all other investments combined. As a result, homeowners are heavily focused on any impact local taxes and expenditures might have on home prices. If, as Part II.B suggests, municipal benefits and municipal taxes are to a large extent capitalized into home values, homeowners will focus on the impact of these benefits and taxes on their home values, largely to the exclusion of ideological or other commitments that might manifest themselves in state and federal elections. In a sense, municipal voters are akin to corporate shareholders who seek to maximize share value, except that the costs associated with exit focus municipal voters even more closely on monitoring local government decisions.

How does that self-interest operate when voters consider local taxes and services? First, consider the case in which a municipality is composed of identical properties, each of which benefits equally from municipal services. In that municipality, taxpayers would presumably support tax increases if and only if the services supported by new taxes would generate more benefits than they entail costs. Each taxpayer would face the same calculus and make her own assessment of benefits and costs. Our general assumption is that the majority of taxpayers...
ers would make a better assessment than the minority, and new taxes would generally be imposed only in those situations where the benefits created justify the taxes imposed.

Such a municipality is purely a hypothetical construct; disparities are inevitable within any municipality. First, homes differ in value. If, however, all municipal benefits are capitalized into home value, each voter-taxpayer will still support only those tax increases that pay for services that generate a surplus of benefits over costs. Those who own more valuable homes will pay a larger share of the additional taxes, but they will also obtain a proportionately larger share of the benefits generated by those taxes.

Second, as we have seen, homeowners derive differential benefits from the same services. Even if many municipal benefits are capitalized into home value, not all of them are. Other things being equal, the homeowner with three children derives more benefits from the public schools than the homeowner with no children or with only one. And once we sever the link between taxes and benefits, the incentives change. Now, the voter-taxpayers who will reap more benefits than the taxes they expect to pay have an incentive to support municipal benefits even when those benefits cost more than the aggregate value they generate for the municipality. Conversely, voter-

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93 Although modeling voting behavior is fraught with difficulty, William Fischel has argued that at the local government level, a median voter model does a good job of predicting government behavior, even if voters never vote directly on the particular issue in question. Fischel, supra note 76, at 49. As Fischel argues further, property taxation "lines up other voters' incentives to make political decisions that are consistent with each voter's desire to maximize the value of his own home." *Id.* at 52.


95 This problem is arguably exacerbated when persons who own no property, and therefore pay no tax, nevertheless vote. *See* Stark, supra note 43, at 214–16 ( canvassing theories supporting, on efficiency grounds, a restriction of the franchise on tax issues, but noting that franchise limitations would offend constitutionally mandated one-person/one-vote principles). If, however, renters bear a share of the property tax in the form of increased rents, this shifting of the tax burden ameliorates any free rider problems.
taxpayers who will pay more in taxes than they expect to derive in
benefits have an incentive to oppose the benefits even if the aggregate
value of those benefits exceed their aggregate costs.

Severance of the link between taxes and benefits does not guaran-
tee inefficiency in provision of municipal services. Voter-taxpayers
may act altruistically, considering the overall benefit and cost to the
municipality rather than the impact on themselves alone.96 Alternatively,
enough voters may have personal interests aligned with aggre-
gate welfare that even if each voter acts in self-interest, the voters as a
body are likely to reach efficient decisions. That is, if benefits are
strongly but imperfectly correlated with taxes, the voting mechanism
is still likely to generate efficient production of municipal services.97
The more attenuated the connection between taxes and benefits,
however, the less likely the voting mechanism will generate efficient
results.

Return to the problem of tax assessments. When tax assessments
are purely arbitrary, the connection between taxes and benefits is sev-
ered completely. Suppose, for instance, that 30% of homeowners are
assessed at $200,000, while 70% are assessed at $20,000. If voters are
considering whether to pay for a service that will benefit each home-
owner equally, voters are likely to approve the service even if costs
grossly exceed benefits; the 70% of homeowners who will bear ap-
proximately only 20% of the costs have strong financial incentives to
approve the expenditures. Conversely, if 30% of homeowners are as-
sumed at $20,000, while 70% are assessed at $200,000, the voters
would be likely to disapprove the expenditures even if aggregate bene-
fits exceed their costs.98

96 See id. at 245–47 (discussing the effect of deliberative processes on views and
voting behavior).

97 The point can also be expressed in terms of the "tax price" faced by voters. The
tax price has been defined as "the cost to an individual of increasing her per
capita share of local public spending by one dollar." Id. at 218. Stark contends that
"[w]here a community's median voter faces a low tax price, the referendum is likely
to exhibit a low level of taxpayer-regardingness, while the opposite would be true
where the median voter faces a higher tax price." Id. at 218–19. Where the median
voter faces a tax price higher than one dollar, however, inefficient decisions might
result when the median voter is paying more than her pro rata share of the commu-
nity's aggregate tax burden—the problem discussed in the next paragraph of the text.

98 The assumption here is that a "median voter" model captures the decisionmak-
ing process in local governments. That model assumes that the level of public services
will be determined as if a referendum among the voters is held on every issue of
concern to voters. Empirical evidence suggests that, within small municipalities, the
median voter model has greater predictive force than competitive models of govern-
Moreover, Tiebout-style competition among municipalities will not cure the problem. Even if inefficient provision of municipal services diminishes, in the aggregate, the attractiveness (and therefore the purchase price) of homes within the municipality, many homeowners will not bear any share of that loss; and for others, any loss will be more than offset by the relative benefits they receive (or relative harms they suffer) from the municipality's disparate assessments.

Take an example. Suppose the municipality plans on borrowing to build a new and larger gym at the local high school. Assume further that over the gym's useful life, it will cost the municipality $1,000,000 per year but will yield only $500,000 per year in aggregate benefits. If we assume, however, homeowners with identical homes, 30% assessed at $200,000 and 70% assessed at $20,000, the gym is likely to be approved overwhelmingly. The low-assessment homeowners will derive 70% of the benefit of the gym ($350,000) but will bear only 14/74 of its cost ($189,190). The result may significantly diminish the market value of the high-assessment homes but will only increase the value of the low-assessment homes.

This analysis suggests that providing an efficient level of municipal services requires a strong correlation between the benefits taxpayers receive and the taxes they pay. That, in turn, suggests that purely arbitrary assessments will generate inefficient municipal services. Moreover, if all benefits from municipal services were capitalized into home value, the analysis would suggest strongly that assessments equal or proportional to current market value are most likely to generate efficient provision of municipal services.

If, however, not all benefits are capitalized into home value, then market value assessments also have the potential to generate inefficient municipal services. Suppose, for instance, the municipality is considering whether to replace school textbooks every five years rather than every ten years. The annual cost of more frequent replacement will be $200,000. Although some of the benefit will be capitalized into home value, some will not: homeowners with children in school benefit more than homeowners without children, and home-

99 This might further suggest that property taxes should be replaced by user fees to the extent that taxes deviate from actual benefits. This is problematic, however, since the deviation seems stronger for education than for other municipal services like police and fire protection. See supra Part II.A.1. Charging parents for the cost of each child's use is problematic since school is mandatory. Perhaps related thereto, charging parents the full cost could result in too little education since education has positive societal externalities.
owners with five children benefit more than homeowners with one. If we assume that frequent replacement generates $300,000 in benefit, only $100,000 of which is capitalized into home value, and if we also assume that assessment is tied to market value, then homeowners without children in the schools are likely to vote against more frequent replacement. If, on the other hand, assessments are lower for homeowners without school-age children—as they might be if assessment were based on purchase price rather than current values—more homeowners without school-age children would support the expenditure, because their share of the tax cost will be closer to the gain they derive from increased home value.\footnote{100}

To summarize, then, whenever the tax burden within a municipality is not distributed in proportion to benefits derived from municipal services, the risk of inefficient taxing and spending decisions increases.\footnote{101} Voter self-interest departs from the aggregate municipal interest, making it less likely that electoral decisions will maximize group welfare. If all benefits from municipal services were capitalized into home price, the efficiency argument for assessment based on market value would be a powerful one (although market value assessment would preclude redistributive taxation).\footnote{102}

Conversely, if the benefits of municipal services are not capitalized into home price, efficiency considerations would support assessment based on purchase price, at least if purchase price roughly provides tax relief to those who have been within the municipality longer and who generally make less of a claim to the most expensive of municipal services—the public schools.

Neither of these alternatives appears likely. If, as appears more likely, benefits are partially capitalized, the optimal assessment base will be somewhere between purchase price and current market value.

\footnote{100} Cf. Fischel, supra note 64, at 263–64 (discussing tax exemptions for senior citizens and tax breaks for farmland as mechanisms to align benefits and burdens to individual landowners with benefits and burdens for the municipality as a whole).

\footnote{101} A similar concern might be raised in connection with redistribution attempts at the federal level. This concern is more acute at the local level, however, for several possible reasons: (1) there is more direct voting on items at the local level; (2) there is more control—actual or perceived—at the local level; and/or (3) the presence of a larger number of issues at the federal level reduces the impact of tax redistribution on voters’ choices.

\footnote{102} Similarly, market value assessment might create liquidity difficulties for some taxpayers. Deferral of taxes attributable to reassessments could, however, address liquidity concerns. See discussion infra Part III.D; cf. Klein et al., supra note 73, at 6 (arguing that while a “narrow view” of ability to pay would consider liquidity, a “broader view . . . would look at people’s material well-being without regard to liquidity”).
The precise balance that will lead to the most efficient provision of municipal services rests on empirical facts; a priori reasoning cannot resolve the issue.

III. PRACTICAL DIFFICULTIES WITH FREQUENT REASSESSMENT AT CURRENT MARKET VALUE

The preceding Part developed a case—albeit an uneasy one—for assessing real property at current market value. Fair market value, however, is a moving target. If tax assessments at any moment are to reflect that moment's value, the municipality must develop a mechanism for keeping up with market values as those values change. This Part examines the practical problems with a property tax system that demands constant—or even frequent—reassessment to reflect changes in market value.

A. Cost

If tax assessment is to reflect current market value, the tax assessor (or a private firm engaged by the municipality to conduct the reassessment) must examine all features of a parcel of property that have an effect on market value. If, for instance, a modern kitchen, a finished basement, or a new bathroom increases the value of a house relative to others in the neighborhood, an inspection of the interior of homes would be necessary to determine whether these features exist.

A class of professionals—appraisers—has developed to conduct these inspections and to make judgments about market value. Appraisers often inspect homes for banks deciding how much security they will enjoy if they make a mortgage loan to a prospective purchaser. Appraisers, however, do not work for nothing. When a municipality sets out to conduct a systematic reassessment of property within its borders, the municipality will typically hire an appraisal firm to conduct a “mass appraisal.”

Nassau County, a large suburban county on New York’s Long Island, conducted a reassessment in 2002. The county contracted to

103 See generally Robinson, supra note 25, at 521–23 (discussing the history of property value assessment).
104 See INT’L ASS’N OF ASSESSING OFFICERS, supra note 40, at 122 (noting that, particularly in older communities, “often the critical characteristics affecting value are inside the house”).
105 Id. at 113 (discussing process of mass appraisal); see also Cook, supra note 32, at 96–97 (comparing mass appraisal to fee appraisal).
pay a private firm $34 million\textsuperscript{106} to reassess the county’s 365,000 residential and 49,000 commercial parcels\textsuperscript{107}—a cost of about $80 per parcel. Smaller municipalities, which cannot offer appraisers the same economies of scale, will no doubt face a higher per-parcel cost.\textsuperscript{108}

Moreover, the initial cost of the reassessment significantly understates its ultimate cost. Once the initial reassessment is “completed,” the municipality must find a mechanism for resolving complaints or appeals by property owners convinced that the initial reassessment overvalued their parcels. Using Nassau County as an example, again, 128,000 property owners—about one-third of the county’s total—filed grievances with the county’s assessment review commission.\textsuperscript{109} Twice as many homeowners contested their assessments as during the preceding year.\textsuperscript{110} Processing these grievances is costly: Nassau County increased the staff of its assessment review commission from one to thirty-two, at an annual cost of nearly $2 million.\textsuperscript{111} That cost, however, represents the tip of the iceberg. Homeowners themselves inevitably spend considerable sums hiring appraisers, lawyers, and firms that specialize in assessment challenges\textsuperscript{112}—expenses that might be worthwhile for individual homeowners, but that represent deadweight losses from a social perspective.\textsuperscript{113}

Moreover, if the goal is to keep assessments tied to current market value, these expenditures are not one-time costs. Housing values change, relatively as well as absolutely. If they did not, there would be

\textsuperscript{108} The Town of Rye, New York, with a total of eleven thousand parcels, has recently engaged a private firm to reassess the town’s properties for a cost of just under one million dollars (about ninety dollars per parcel). Rubenstein, \textit{supra} note 7.
\textsuperscript{110} Id.
\textsuperscript{111} Id. The county also spent $4,600,000 to upgrade its computer system to assist in the valuation process. Id.
\textsuperscript{112} See Toy, \textit{supra} note 107 (noting that tax challenge companies encourage homeowners to challenge assessments by offering contingent fees for processing challenges).
\textsuperscript{113} See Zelinsky, \textit{supra} note 33, at 881–82 (noting expenses). In addition, as Noë1 Cunningham and Deborah Schenk have noted, whenever taxation depends on appraisal, the government tends to lose revenue because government does not have the resources to compete with private litigants in disputes over appraisal. See Noë1 B. Cunningham & Deborah H. Schenk, \textit{Taxation Without Realization: A “Revolutionary” Approach to Ownership}, 47 Tax L. Rev. 725, 743 n.78 (1992).
little pressure to reassess. But the more frequent the reassessment, the greater the cost to the municipality.

B. Accuracy

When a municipality conducts or commissions a reassessment, its objective is to determine the market value of each parcel of land even though the parcel’s owner has not seen fit to place the parcel on the market. The principal mechanism for determining market value of residential homes is comparison with the selling price of homes that have recently changed hands; for those homes, market value is relatively clear. But if comparable sales are critical, the first question to consider is sales during what period of time? Are five-year-old sales relevant to current market value? Ten-year-old sales? The premise behind reassessment to current market value is that market value changes over time; if values were constant, old assessments would be as good as new ones. Use of a five-year-old sale as a benchmark for value creates two problems: first, absolute values of all homes within the municipality may have changed during that period; and second, the relative values of homes within the municipality may have changed. Appraisers can attempt to use an indexing factor as an imperfect way to deal with the first problem. Indexing does not help at all with the second problem. As a result, how to use past sales to determine current value remains a matter that is part science, part art.

The next difficulty is determining what homes are comparable and what sorts of adjustments should be made for differences among “comparable” homes. Objective features such as lot size, house square footage, and number of bathrooms are easy to compare but play only

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114 For investment properties, the comparable sale approach competes with two others: the cost approach and the income approach, neither of which is well suited to residential homes. For fuller descriptions of these approaches, see Cherokee W. Wooley, Regulation of Real Estate Appraisers and Appraisals: The Effects of FIRREA, 43 Emory L.J. 357, 362-63 (1994).

115 As Saul Levmore has noted, the quest for market value is not problem-free even when the property has been subject to recent sale unless the market for the property is active and not subject to fluctuations. Saul Levmore, Self-Assessed Valuation Systems for Tort and Other Law, 68 Va. L. Rev. 771, 774 (1982). Levmore hypothesizes a scenario in which a purchaser willing to pay one hundred thousand dollars or more for a house the seller is then unwilling to sell, followed by an actual sale at ninety-five thousand dollars just after the initial bidder has disappeared from the market. Levmore asks, rhetorically, “[w]hat is the market value of the house?” Id. at 775-76.

116 See Wooley, supra note 114, at 391 (“The inherent subjectivity involved in the appraisal of real property means that the process of appraising can never be an exact science.”).
a partial role in determining market value.\textsuperscript{117} Neighborhood quality is often critical, but defining the relevant neighborhood is often difficult.\textsuperscript{118} "Curb appeal" is similarly difficult to measure, as is the quality of initial building materials and the condition in which the home has been maintained.\textsuperscript{119} Moreover, even with recent improvements, determining value is difficult; cost rarely provides a good estimate. A homeowner who spends $10,000 on a new Sears kitchen may substantially increase the value of a $100,000 home; the same kitchen might add no value at all to a $600,000 home because the typical buyer of that home would rip it out in favor of more upscale cabinets, appliances, and countertops. Exacerbating the problem is the impact of tax assessments on value. The sale price of a "comparable" home may reflect an underassessment or overassessment of that home's value because, as the last subpart demonstrates, a significant portion of the tax burden is typically capitalized into value.\textsuperscript{120} This tax capitalization further complicates treatment of "comparable" homes for assessment purposes.

Legal doctrine has long recognized the difficulties associated with nonmarket determinations of market value. In a variety of areas, legal doctrines have developed that avoid the need for speculative determin-
nations of market value. Perhaps the most basic of these—although certain not the only one—is the doctrine that because real property is unique, a contract vendee is entitled to specific performance of a contract to sell real property. Against this background, then, it is hardly surprising that experts criticize the accuracy of real property assessments, even when municipalities attempt to keep them current.

C. Politics

The thrust of the preceding subpart is that even trained appraisers seeking to determine market value are ultimately doomed to significant inaccuracy. In fact, however, tax assessment is a political process; the ultimate responsibility for assessments rests on the shoulders of elected officials, and they have incentives to minimize any damage to their political careers that reassessment might generate.

The extreme case involves out-and-out corruption; favored individuals receive low assessments in return for the benefits they confer on assessors. The frequency of this kind of corruption is difficult to detect, because other taxpayers have limited incentive to monitor this sort of “sweetheart” assessment. A landowner concerned about his own tax burden will be much more likely to fight about a $25,000 overassessment of his own parcel than a $250,000 underassessment of someone else’s parcel. Because the burden of the underassessment is shared by so many taxpayers, each of whom suffers very little, none of them have much reason to challenge the underassessment.

Undoubtedly more common than out-and-out corruption is the ordinary political desire to please constituents. Reassessment inevitably leaves many taxpayer-voters unhappy with their assessments. Politically

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121 Restatement (Second) of Contracts § 360 cmt. e (1979).

Contracts for the sale of land have traditionally been accorded a special place in the law of specific performance. A specific tract of land has long been regarded as unique and impossible of duplication by the use of any amount of money. Furthermore, the value of land is to some extent speculative. Damages have therefore been regarded as inadequate to enforce a duty to transfer an interest in land . . . .

Id.

122 See, e.g., Levmore, supra note 115, at 777 (quoting census statistics indicating that a small percentage of municipalities kept dispersion ratios for valuation of non-farm houses within fifteen percent of the median assessment ratio).

123 See Zelinsky, supra note 6, at 2203 (linking the “considerable political manipulation” to the valuation difficulties).

124 Cf. Russell, supra note 119 (discussing resignation of the chair of the state tax commission after he and a number of assessors “went on annual fishing junkets paid for by an energy firm with business before the commission”).
ical officials will find it attractive in that circumstance to admit the
possibility of error, especially when the error can be attributed to
someone else, here the outside firm commissioned to conduct the re-
assessment. That, in turn, will typically lead to development of a pro-
cess for reviewing initial assessments, generally in the name of
accuracy and fairness.

Once a review process is in place, however, the potential for com-
pounding errors is at least as great as for correcting them. Typically, a
large percentage of taxpayers who seek review of their assessments will
receive reductions. One explanation for the large percentage of
reductions is that the original assessment process was terribly flawed,
generating a large percentage of errors. If that was the problem, the
review process would not restore equity; those taxpayers who do not
challenge their assessments would remain burdened by their flawed
assessments.

Another explanation for a high percentage of reductions—the
one most likely to be offered by municipal officials—is that the taxpay-
ners who seek review are those most likely to have been unfairly as-
essed. Those who did not seek review were disproportionately the
taxpayers who were treated fairly in the reassessment process; hence,
they had no reason to complain and small likelihood of success.

In fact, however, this explanation is about as plausible as the con-
tention that students who complain about grades are disproportio-
nately those who have suffered unfair treatment. The more likely
explanation is that the taxpayers who challenge their assessments are
disproportionately those who have the savvy to understand that they
have little to lose; review processes rarely provide for the possibility of
increased assessment. Moreover, reviewing these assessments in iso-

125 For instance, in a recent revaluation of properties within the Town of Rye, New
York, twenty-five percent of property owners requested a review of their assessments,
and two-thirds of those received a reduction. Hannan Adely, Rye Town Residents Di-
vided on Accuracy of Property Reviews, THE J. NEWS (Westchester County, N.Y.), June 13,
2004, at 1B.

(quoting director of the District of Columbia’s assessment office, who justified reduc-
ing assessments only for landowners who complained about possible chemical con-
tamination and not for similarly situated landowners who did not complain, by
asserting that, in the Post’s words, “those who did not appeal their bills are presuma-
bly content with the assessment on their properties”).

127 See, e.g., N.Y. REAL PROP. TAX LAW § 525(3)(b) (McKinney 2000) (“The final
assessed valuation or taxable assessed valuation of real property may be the same as or
less than the original assessment.”).

Commercial landowners tend to challenge assessments in far greater numbers
than residential homeowners, both because they have more at stake and because they
lation, without reviewing the assessments of more passive taxpayers, is hardly likely to increase overall accuracy; the new reductions may harm taxpayers who previously had no cause to complain but who now find themselves overassessed relative to their more aggressive neighbors.\textsuperscript{128}

\textbf{D. Liquidity}

Within the income tax literature, a standard defense of the realization requirement focuses on taxpayer liquidity: if a taxpayer is required to pay tax on gains before the taxpayer sells the asset, the taxpayer may be forced to sell the asset in order to pay the tax.\textsuperscript{129} A realization requirement assures that taxpayer’s tax liability comes at a time when the taxpayer has cash with which to pay the tax.

Liquidity is of particular concern when the property tax is at issue.\textsuperscript{130} In an income tax system that relies heavily on withholding, tax generally is paid out of income the taxpayer has just earned. Similarly, a taxpayer has no occasion to pay sales tax unless the taxpayer has liquid assets with which to make a purchase. By contrast, when property tax comes due, there is no assurance that the taxpayer will have available a stream of money that bears some proportion to the tax due.\textsuperscript{131}

To some extent, the liquidity problem is mitigated by the taxpayer-homeowner’s ability to plan at the time of purchase. When a person buys a home, she knows and accounts for her prospective property tax liability, just as she accounts for her monthly mortgage payments. Indeed, the mortgagee bank will generally take tax liability into account in determining the size of mortgage for which the purchaser qualifies, and the mortgagee bank may require the purchaser

\begin{itemize}
\item \textsuperscript{128} For a discussion of the parallel problem with respect to law school grades, see Stewart E. Sterk, \textit{Information Production and Rent-Seeking in Law School Administration: Rules and Discretion}, 83 B.U. L. Rev. 1141, 1152 (2003).
\item \textsuperscript{130} See, e.g., Miller, supra note 5, at 86 (asserting the property tax’s failed connection to liquidity is a “further problem . . . which is central to its disfavor with taxpayers”).
\end{itemize}
to set up an escrow account to assure that those taxes are paid on a monthly basis. Modest annual property tax increases—like modest increases in the price of consumer goods—are unlikely to raise significant liquidity concerns.

Reassessment, by contrast, can significantly increase a homeowner's tax burden when the homeowner has no ready source of funds available to pay the increase.\textsuperscript{132} Liquidity can be especially serious as a problem for long-term homeowners, who made purchasing decisions based on incomes and tax burdens that no longer reflect current ability to pay.\textsuperscript{133}

One answer to this liquidity problem is to suggest that homeowners without liquid assets to meet current tax burdens should move to homes and communities whose prices and tax structures are more in line with their own liquid resources. That answer, however, is politically unpopular; no local politician concerned about reelection would suggest that moving out is the best answer for local residents facing liquidity problems.\textsuperscript{134} Moreover, involuntary relocations involve significant costs. People who retain homes that are larger than they need are not necessarily acting irrationally; social networks, memories, time, and money spent tailoring a particular home to one's own preferences combine to make a home more valuable to its current occupant than it would be to a similarly situated prospective purchaser. That subjective value is lost when liquidity problems force a long-term resident to relocate.

As a result, the more common municipal response to liquidity problems is a reduction in tax burdens for long-term residents through "circuit breaker" provisions of one sort or another. These provisions—limited exemptions and income-related tax rebates\textsuperscript{135}—do not typically result in a reduced assessment of property value, but

\textsuperscript{132} To the extent higher reassessments are matched by higher home values, some taxpayers might be able to borrow against the appreciation to fund the property tax increase. This is not a comprehensive solution to liquidity concerns, however. The lack of an attendant cash flow increase to support a traditional mortgage might force the taxpayer to utilize a reverse mortgage with high charges. \textit{Cf.} Youngman, \textit{supra} note 37, at 747–48 (discussing how taxpayers underutilize state deferral programs in part due to their high charges).

\textsuperscript{133} \textit{See} Gold, \textit{supra} note 34, at 155.

\textsuperscript{134} \textit{See} Zelinsky, \textit{supra} note 6, at 2207 ("[I]t is not a politically compelling defense of the local property tax . . . that homeowners' liquidity complaints may indicate that they are overhoused.").

\textsuperscript{135} For a comprehensive discussion of circuit-breakers, see Gold, \textit{supra} note 34, at 148–58. \textit{See also} William Duncombe & John Yinger, \textit{Alternative Paths to Property Tax Relief}, in \textit{PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE}, \textit{supra} note 14, at 243, 253 (discussing use of circuit-breaker programs among the states); LaFrance, \textit{supra}
they do achieve a practically equivalent result: they divorce the homeowner’s tax burden from the value of her property. The consequence is that even if a municipality manages to overcome all of the costs and inaccuracies associated with assessment at current market value, the overall tax burden is not proportional to market value.

IV. Reform Proposal: Deferral of Revaluation Until Sale

The current property tax choices leave unsatisfactory tradeoffs. A system that bases tax assessments on an owner’s initial purchase price—a “purchase price” approach—raises significant equity, efficiency, and perception concerns. A system that directly links taxes to current market value reduces these concerns in theory, but could introduce voting distortions of its own. Moreover, administrative and political pitfalls riddle existing attempts to value homes prior to sale.

To address these difficulties, we propose a new property tax structure which combines the most attractive features of the purchase price and current market value approaches. In essence, we propose a system that reassesses property only upon sale—avoiding the cost, valuation, and liquidity difficulties that plague property tax systems that focus exclusively on current market value. At the same time, we propose a tax adjustment at the time of sale that recaptures from the seller most of the tax benefits the seller received from below-market assessments.

We recognize that in a number of states, implementation of our proposal would require not only legislation, but constitutional amendment. And in other states, a system that reassesses property upon sale might, as a practical matter, require adjustment of constitutional limitations on local taxing power.136 We do not consider in this Article the precise steps necessary to enact our proposal in each of the fifty states.

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131 note 131, at 840–42 (discussing tax deferrals and exemption policies for homeowners).

136 Some states limit local taxing power to a percentage of property value. See, e.g., CAL. CONST. art. XIII, § 1(a) (requiring property tax to be assessed as a percentage of fair market value); WASH. CONST. art. VII, § 2 (requiring supermajority to impose tax in excess of one percent of fair value). If value for property tax purposes were fixed at purchase price—an amount often less than current value—existing constitutional limitations might begin to constrain municipalities not constrained under existing law.
A. The Initial Reform Proposal: Mechanics

Our reform proposal uses both purchase price and current market value. Each home would be reassessed upon sale, and the assessment would then remain constant for as long as the taxpayer-homeowner owns the home. When the home is sold or the homeowner dies, the homeowner or her estate would become liable for additional tax based on the home’s increase in value. In effect, the tax liability for each ownership year would be redetermined at sale by averaging the original purchase and final sales prices. Additional tax would be due on sale equal to the difference between (1) what the taxpayer would have paid each year had the home been assessed at the average between purchase and sale prices, and (2) what the taxpayer actually paid each year.\(^{137}\)

Example 1. \(H\) buys a home for $100,000 on January 1, 2001, and sells it for $500,000 on January 1, 2021. The tax rate equals 1% for each year. \(H\) pays $1000 tax in each of years 2001–2020, based on the $100,000 historical cost. \(H\) pays $40,000 additional tax on sale in 2021, calculated as follows. The average value of the home during the twenty-year period was $300,000. \(H\) owes $2000 back taxes for each of the twenty ownership years: the difference between the $3000 per year \(H\) would have paid with a $300,000 assessment and the $1000 per year \(H\) actually paid.

B. The Initial Reform Proposal: Improvements on Current Options

1. Improvements over Assessment Based Only on Initial Purchase Price

   a. The Relationship Between Benefits and Taxes

   Recall that a pure purchase price approach significantly deviates from the benefits justification for the property tax by ignoring benefits capitalized into home price. That is, many of the benefits generated by municipal services are capitalized into the current market value of homes within the municipality. When assessments depart significantly from current market value, as they do when assessments are based solely on purchase price, taxes will not accurately reflect benefits received.

   As we have seen, a discontinuity between taxes and benefits generates a moral hazard problem when taxpayers vote on municipal services. In particular, taxpayers whose purchase price assessments are

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\(^{137}\) This assumes the typical case where the home is sold at a gain. Refunds could be provided to homeowners who sell at a loss.
too low have incentives to vote to increase municipal services even when the cost of those services will exceed their benefits. While tax rate caps address this concern, they also impede efficient spending decisions.138

Our proposal addresses this problem without inefficient rate caps by assuring that long-term homeowners will bear more of the cost of municipal services. At the same time, the additional taxes will be paid at a time when assets (the sale price) are available to pay those taxes.139

b. Ability To Pay

If the property tax were treated as an ability-to-pay tax, pure purchase price disregards a clear accession to wealth in its very base.140 The value of one’s property is certainly an element of one’s ability to pay. Our proposal includes that value in the tax base but postpones the tax until sale, minimizing ability-to-pay arguments based on taxpayer liquidity.141

c. Inefficient Incentives To Retain Homes with Appreciated Value

A property tax based purely on the owner’s purchase price distorts selling decisions, because the sale of an appreciated home increases the tax burden, thus encouraging retention of appreciated homes to avoid the tax increase which accompanies a sale.142 As evi-

138 See supra text accompanying notes 22–24 (discussing California’s Proposition 13).
139 Voters might discount future tax liabilities for a variety of reasons. As discussed infra text accompanying note 159, this might be desirable since benefits and value do not correlate perfectly.
140 Recall the broader definition of ability to pay, which looks to material well-being irrespective of the liquidity of assets.
141 See Miller, supra note 5, at 130–32 (critiquing the purchase price approach on equity grounds); id. at 86 (noting liquidity problems with value-based taxes).
142 One example of this distortion is the tax incentive to make intergenerational transfers to family members under California’s Proposition 13. See Joan M. Youngman, The Hardest Challenge for Value-Based Property Taxes: Part II, 16 ST. TAX NOTES 1393, 1395 (1999). On the flip side, a pure purchase price approach encourages sales when home value decline.

Nada Wasi and Michelle J. White have conducted an empirical study that documents the tendency of pure purchase-price assessments to increase the tenure length of property owners. Their study concludes that in California, tenure length of homeowners increased substantially after enactment of Proposition 13 relative to tenure length changes in Texas and Florida during the same period. Nada Wasi & Michelle J. White, Property Tax Limitations and Mobility: The Lock-In Effect of California’s Proposition
denced by the following examples, while our proposal would not elim-
minate all such distortion, it would significantly reduce the concern
compared to the purchase price approach.\textsuperscript{143}

Assume $H$ buys a home for $1,000,000$ on December 31, 2000,
and the home appreciates at a constant rate of 7\% per year. After one
year, on January 1, 2002, the home will be worth $1,070,000, and five
years later, on January 1, 2007, the home will be worth about
$1,500,000.\textsuperscript{144} Suppose $H$ considers selling the home on January 1,
2002. Assume the property tax is a constant 1\% during that period.
What property tax implications will sale have, first if the tax is based
solely on purchase price, and second, under our approach?

Example 2A (Purchase Price Approach). If $H$ retains the original home
until 2007, his tax during that period will be a constant $10,000 per
year. By contrast, if $H$ sells the home on January 1, 2002, and buys a
home of equal value on the same date, $H$ will pay an additional
$700 in tax for each of the five years between January 1, 2003, and
January 1, 2007, for a total of $3500. That is, $H$ is $3500 better off if
$H$ retains his original home, even if he would prefer another home
of identical market value.

Example 2B (Proposed Approach). If $H$ retains the original home until
2007, his tax during the six-year period will be $10,000 per year. At
sale, $H$ will pay an additional tax based on the average value of his
home during the period. Because the average value was $1,250,000,
he will pay the difference between $12,500 and $10,000 for each of
the six years, for a total of $15,000. His total tax payments for the
six years, including the catch-up payment at sale, will be $75,000.

If $H$ sells the original home on January 1, 2002 and purchases
one of equivalent value, his tax for the last five years will be $10,700
per year, reflecting the purchase price of his new house. In addition,
he will pay two adjustments, one upon the sale of each house. At the
sale of the first house, he will pay an additional $350 (1\% of the difference
between the average price of his house during the one year he
owned it and the purchase price of that house). At the sale of the

\textsuperscript{13} (Nat’l Bureau of Econ. Research, Working Paper No. 11108, 2005), \textit{available at}

\textsuperscript{143} Elimination of such distortion generally would require a precise revaluation
for each year, and a precise interest charge for any deferred tax payments. \textit{See infra}
Part IV.C.2. This distortion also would be eliminated by an approach which disre-
garded completely sales of a home in determining its tax charge (such an approach
would raise other concerns, of course). As such, selling distortion also arises under
periodic revaluation assuming it gives weight to a sale of the home in question during
the interim period.

\textsuperscript{144} $1,000,000 \times (1.07)^6 = $1,500,730$. The example includes rounding for ease of
calculation.
second house he will pay an additional $10,750 (1% of the difference between the average price of the house during the five years he owned it and the purchase price of that house, multiplied by the five years he owned the house). His total tax payments for the six years will be $74,600.

The proposed approach eliminates most of the distortion associated with tax assessments based solely on initial purchase price. The incentive to retain a home whose value has appreciated largely disappears; in the example, the taxpayer who retains the home actually pays somewhat more tax (although the actual burden may be no larger, or somewhat less, because more of the tax is deferred).

d. Perception of Unfairness

Finally, we have seen that the purchase price approach generates a perception of unfairness, which lingers even if tax capitalization reduces the actual inequities. The proposed approach addresses that perception, because all homeowners should recognize that those whose assessments are now low will make up the difference at a later date.

2. Improvements over Assessments Based on Current Market Value

a. Valuation Difficulties

As we have seen, periodic revaluations—annual or otherwise—also remain unsatisfactory notwithstanding their superficial appeal as a response to the purchase price problems. As evidenced by extensive experience, valuation attempts prior to sale raise significant difficulties: they are costly, unreliable, and beset by political problems. Our approach avoids these problems by eliminating the need for appraisals or assessments.

b. Liquidity

One of the principal criticisms of assessments based entirely on current market value is that homeowners may not have the liquid resources necessary to pay the tax. These liquidity concerns often lead to selective exemptions and deferral opportunities, which furthers the uneven, at times arbitrary, application of the tax. Our approach eliminates liquidity concerns by postponing payment until a pot of
money—the sale proceeds—becomes available for payment of tax obligations potentially unforeseen at time of purchase.145

c. The Connection Between Taxes and Benefits

To the extent that benefits associated with municipal services are not perfectly capitalized into home values, assessments based on current market value will not reflect benefits received by taxpayers and have the potential to introduce moral hazard problems into the voting process. Our proposal ameliorates this problem by delaying the tax obligation of long-term homeowners until they sell their current homes.

As we have seen, long-term homeowners assessed at full market value often have incentives to vote down efficient expenditures—particularly school expenditures—to the extent that the benefits associated with those expenditures are not capitalized into current market value. If, however, they discount the burden of future taxation—as is likely if liquidity is a significant concern—those incentives are reduced somewhat.146

In addition to lesser current tax payments, the real tax charge would move towards historical cost and away from an exclusive focus on current value if no interest were charged on recalculated back taxes.147 This might appeal on equity grounds. Recall how historical cost and value each might correlate positively with the benefits and redistribution theories, albeit with varying degrees of precision.148

C. Possible Refinements

Our proposal would not "solve" all problems with the existing options. In fact, no proposal can reconcile all competing concerns even

145 Recall how current deferral options provide a far less comprehensive liquidity response. See discussion supra note 132 and accompanying text. In addition, these current law approaches do not address revaluation concerns.

146 Similarly, the deferred payment addresses the concern to the extent voters do not perceive fully the notion of future tax liabilities. Cf. Stark, supra note 43, at 224–25 ("[I]n terms of the potential effect on the local residents voting behavior, an unperceived burden is indistinguishable from no burden at all.").

147 We consider below the merits of an interest charge on recalculated back taxes. See infra Part IV.C.2. We analyze the respective merits of either no interest charge or an interest charge at the government's low risk-free rate. The real tax charge would move towards historical cost and away from value in either case as owners of appreciated homes would receive the equivalent of a below-market loan from the government.

148 See discussion supra Part II. Notwithstanding such movement towards benefits, the case is more mixed whether this would address inefficient voting decisions. See discussion infra Part IV.C.2.
in theory. There is inevitable tension between the benefits and ability-to-pay theories. And when benefits diverge from value, tension can arise between efficient voting decisions and efficient selling decisions by homeowners. Our proposal nonetheless remains a significant improvement upon current law. We turn next to some refinements which might further improve current law.

Mindful that jurisdictions might resolve differently the competing tradeoffs, our guidance here generally takes the form of recommendations rather than definitive conclusions. For instance, some choices would move our system more in the direction of a pure value tax. Those options might be more attractive in large urban coastal areas where appreciation constitutes a higher proportion of a typical homeowner’s return from the housing investment. More generally, jurisdictions might balance differently the equity and efficiency tensions above, as well as administrative issues. In sum, our analysis above supports some direct link between the property tax and fair market value, but it does not necessarily compel the closest possible connection. And our proposal provides that strong, yet flexible, link.

1. Gain Allocation

Our initial proposal retroactively assessed a new and constant property value for each year, equal to purchase price plus half the gain on sale. As demonstrated above, our proposal, even in its simplest form, would significantly improve upon current law. We believe, however, that two potentially attractive alternatives might more accurately approximate actual property values during the ownership period.

a. Constant Return Assumption

The approach we have used so far focuses on the average value of the home during the owner’s period of ownership. The average value approach effectively assumes that the home appreciated in equal dol-

lar increments for each year that the owner owned the home.\textsuperscript{150} In fact, however, it is more likely that the home appreciated at a constant percentage rate during that time. As illustrated by the following example, a long-term homeowner typically would owe more tax under the average value approach than if we assume appreciation at a constant rate.\textsuperscript{151} That result follows because the average value approach allocates too much appreciation to the early years of the owner's tenure. That problem can be cured by assuming the home appreciates at a constant rate during the period between purchase and sale.\textsuperscript{152} The following examples illustrate the difference.

Assume \( H \) buys a home for $100,000 on December 31, 2000, and the home appreciates at a constant rate of 10\% per year. \( H \) sells the home for $259,375 on January 1, 2011.\textsuperscript{153} Assume the property tax is a constant 1\% at all times. How much tax would \( H \) owe, first under our proposal with an average value assumption, and second, with an assumption that the property appreciates at a constant rate?

\textit{Example 3A (Proposed Approach/Average Value Assumption).} \( H \) pays $1000 tax in each of years 2001–2010, based on the $100,000 historical cost. At sale on January 1, 2011, \( H \) will pay an additional tax based on the average value of his home during the period. Because the average value was $179,688, he will pay the difference between $1797 and $1000 for each of the ten years, for a total of $7970. His total tax burden for the ten years will be $17,970.

\textit{Example 3B (Proposed Approach/Constant Return Assumption).} \( H \) pays $1,000 tax in each of years 2001–2010 based on historical cost, just like Example 3A. \( H \)'s additional tax on the January 2011 sale will be based on the following year-end values: $110,000 (year 01); $121,000 (year 02); $133,100 (year 03); $146,410 (year 04); $161,051 (year 05); $177,156 (year 06); $194,871 (year 07); $214,358 (year 08); $235,795 (year 09); $259,375 (year 10). These values would be assumed based solely on purchase and sales price, thereby avoiding the pre-sale valuation problems. \( H \) would owe $7,533 on sale: $100 + $210 + $331 + $464 + $611 + $772 + $949 + $1144 + $1358 + $1594. \( H \)'s total tax burden for the ten years will be $17,533.

\textsuperscript{150} This result when the tax rate is constant. For an analysis of tax rate changes, see infra Part IV.C.3.

\textsuperscript{151} This ignores time value of money issues. A possible interest charge is discussed infra Part IV.C.2. In certain cases, a homeowner could owe less tax, such as where the home is owned for a short time period. See infra Part IV.C.2.

\textsuperscript{152} The original issue-discount provisions of the federal income tax adopt this concept for bonds which defer some or all of the interest. I.R.C. §§ 1271–1275 (2000).

\textsuperscript{153} $100,000 \times (1.1)^{10} = $259,375. The calculation is rounded to the nearest dollar.
What should we make of this difference? On the one hand, a $437 differential might not seem overly significant on these numbers. On the other hand, the deviation becomes more pronounced as the ownership period or the annual rate of return increases.\footnote{A homeowner could in fact pay less tax under the average value assumption due to a relatively short holding period and/or low rate of return.}

In most circumstances, the constant return assumption better reflects the usual appreciation path.\footnote{The following formulas generalize the difference between the two approaches. The constant return assumption would require the following payment on sale: the sum of $[(1 + R)^N - 1] \times P \times T$, as $N$ ranges from 1 to the number of ownership years, where $N$ is the number of ownership years, $P$ is the purchase price, and $R$ is the annual rate of return. In contrast, average value would include: $2 \times N \times [(1 + R)^N - 1] \times P \times T$.} Constant return’s theoretical advantage must be balanced against administrative concerns, however.\footnote{We focus on maximizing the correlation to a pure value-based tax since unlike the interest charge analysis, see infra Part IV.C.2, value deviations do not move the tax liability towards a possible alternative desideratum such as purchase price. See discussion infra note 170 and accompanying text.} Although a simple computer program could determine the constant return liability by plugging in purchase price, sales price, and years of ownership, a typical homeowner might have difficulty determining his own liability and/or understanding the basis of the charge.

b. Adjusted Constant Return Assumption

The constant return assumption better approximates value than the assumption of appreciation in equal dollar increments. The actual appreciation path, however, is likely to be somewhat bumpy. The constant return assumption results in too much (little) tax relative to value where the home experiences disproportionate appreciation late (early) in the holding period. Most localities have data about general housing price patterns. This data could be used to improve the annual assessments without opening up pre-sale valuation concerns.\footnote{For example, $H$ purchases a home in year 0 for $100,000 and sells in year 3 for $200,000. The general housing market in the locality increased by 20% in year 1, 40% in year 2, and 10% in year 3. The expected value of the house would have been $120,000 after one year, $168,000 after two years, and $184,800 after three years. Because the actual value at sale was $200,000, the expected value for each year would be multiplied by (200,000/184,800).} Again, the theoretic appeal must be balanced against administrative costs, mindful that even simpler versions of our proposal would significantly improve upon current law. If adjusted constant return is rejected on administrative grounds, unadjusted constant return
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Generally should provide a better approximation than average value.  

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2. Interest on Deferred Taxes

We now consider whether homeowners should pay interest on deferred taxes. Starting with the assumption that the property tax should be based on current value, long-term owners would remain tax advantaged absent an interest charge, even if assumed and actual annual property values perfectly correlate. This results since the failure to charge interest on back taxes provides an interest-free loan equivalent to the owner of an appreciated home. An interest charge on the deferred taxes therefore appeals as the natural response.

As suggested earlier, however, some benefits—particularly public schools—are not fully capitalized into home price, and the benefits received by long-term residents may not correlate with home value. If so, foregoing interest on deferred taxes might better align the real tax burden and benefits. On the other hand, in a world of revenue neutrality, an interest charge reduces the annual taxes paid by residents of the municipality. If we assume that liquidity is a concern for many of the long-term residents, especially those who have retired, immediate tax relief may be as significant, or more significant, than the prospect of an interest charge not payable until death or sale. For these residents, saving a dollar now may seem preferable to saving more at death or sale. In addition, the connection to efficient voting is somewhat mixed even for those who act on the basis of real tax charges; i.e., an interest charge might lower the overall real burden for some long-term owners.

The theoretic appeal of an interest charge must be balanced against practical concerns. In theory, interest arguably should be charged at the individual taxpayer’s borrowing rate, taking into ac-

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158 Average value could minimize deviations relative to (unadjusted) constant return in certain cases such as where a home experienced unusually heavy appreciation during the early part of the holding period. \( \text{Unadjusted constant return would result in too little tax, and the average value excess tax would serve as an offset.} \) Absent some showing that average value is more likely to offset, rather than exacerbate, uneven appreciation deviations, (unadjusted) constant return’s greater plausibility should trump.

159 Even with the resulting higher tax rates, long-term owners generally benefit from the lack of an interest charge since the deferral benefits increase with the deferral period. An interest charge would reduce a long-term owner’s current tax burden at some point, as the selling date nears. Accordingly, foregoing an interest charge—with the corollary higher rates—could exacerbate the voting concern for long-term owners who have reached this crossover point.
count variations over time. Individual-specific borrowing rates are impractical, however, and might restore liquidity concerns, especially for long-term homeowners with poor credit.

After balancing the theoretic and practical concerns, we generally recommend an interest charge at the U.S. government’s low risk-free rate. In recommending the interest charge, we are particularly mindful of the income tax’s legendary difficulties with interest-free deferral. Nonetheless, we recognize that some jurisdictions might prefer to drop the interest charge, perhaps to move the real tax burden more towards purchase price. This might appeal more so for equity reasons than efficiency reasons. In this regard, interest-free deferral might be a lesser concern under the property tax due to differences between the property and income taxes.

160 For a limited argument supporting the risk-free rate in theory in a comparable context under the federal income tax, see Cynthia Blum, New Role for the Treasury: Charging Interest on Tax Deferral Loans, 25 Harv. J. on Legis. 1, 15 (1988) (noting that taxpayers holding risk-free treasuries would liquidate those assets to fund earlier tax payments). Separately, the federal AMT might offset concerns that a risk-free interest charge is too low. The AMT denies the federal tax deduction for property taxes in certain cases, which is more likely as the amount of property taxes in any year increases. I.R.C. §§ 55, 56(b)(1)(A)(ii) (West Supp. 2005). Absent some adjustment, our proposal would increase the likelihood of an AMT disallowance given the lump-sum payment at sale, and such AMT denial could be viewed as an implicit charge for deferral.

161 E.g., Blum, supra note 36. Retrospective approaches have been suggested under the income tax, primarily to address interest-free deferral. E.g., Alan Auerbach, Retrospective Capital Gains Taxation, 81 Am. Econ. Rev. 167 (1991); Blum, supra note 36. Setting aside the interest charge, retrospective allocations are more important under the property tax than under the income tax since the property tax applies a relatively low rate on a repetitive basis.

162 While dropping the interest charge generally would move the real tax burden towards purchase price, the impact on voting is unclear. See supra notes 146–148 and accompanying text. This nonetheless might be desired on equity grounds since both purchase price and value might correlate positively with the benefits and redistribution theories. An interest charge at the low risk-free rate similarly moves the real tax burden towards purchase price, albeit to a lesser extent.

163 Interest-free deferral raises three categories of problems under the realization income tax: (1) indefinite gain deferral by avoiding realizations on appreciated assets; (2) selective loss transactions, particularly utilization of non-economic losses to offset real income; and (3) capital gain conversion transactions which transmute ordinary income into low-rate capital gains. A property tax on homes does not implicate the latter two, and the first might be less problematic due to greater difficulty in cashing out without an actual sale. Cf. I.R.C. § 1259 (2000) (attempting to deal with “constructive sales” on appreciated financial positions). Nonetheless, some concern does remain given the possibility of devices such as long-term leases. Special avoidance rules could deal with this problem; e.g., long-term leases could be treated as sales, with the sales price determined from the lease’s revenue stream. Also, the federal
3. Tax Rate Changes

We have so far assumed a constant tax rate. We now consider two alternatives for rate changes: actual versus average rates. Each year's reassessed amount at sale could be multiplied by such year's actual rate or the average rate over the ownership period. As evidenced by the following examples, actual tax rates work better in conjunction with constant return assumptions than average value.

Assume $H$ buys a home for $100,000 on December 31, 2000, and the home appreciates at a constant rate of 50% per year. $H$ sells the home for $506,250 on January 1, 2005.\(^{164}\) Assume the property tax rate is 1% for 2001–2003 and 3% for 2004. How much tax would $H$ owe under the alternative average value or constant return assumptions, first using actual tax rates, and second, utilizing the average tax rate?

**Example 4A (Actual Tax Rates).** $H$ pays $1000 tax in each of years 2001–2004 based on historical cost. $H$'s additional tax on the 2005 sale depends on whether the constant return or average value assumption is adopted. Average value would add $203,125 to the tax base for each year.\(^{165}\) $H$ owes $2031 for years 2001–2003 and $6094 for 2004, for an aggregate $8125 payment on sale. A constant return assumption would add $50,000; $125,000; $237,500; and $406,250 to the base for years 2001–2004 respectively. Accordingly, $H$ would owe $16,312.50 on sale.\(^{166}\)

**Example 4B (Average Tax Rate).** $H$ pays $1000 tax in each of years 2001–2004 based on historical cost, just like Example 4A. The additional tax on the 2005 sale will now be based on the average 1.5% rate.\(^{167}\) Accordingly, $H$ would owe $3047 for each of the four years under an average value assumption, for an aggregate payment of $12,188.\(^{168}\) Under a constant return assumption, $H$ would owe additional tax of $12,281.\(^{169}\)

As evidenced by these examples, actual tax rates are less effective in tandem with average value in the typical case where the gain amount increases over time. By allocating a constant gain amount to

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income tax exclusion for qualifying gain on home sales should minimize certain tax avoidance attempts; e.g., classification of purchase price as interest on seller-financed sales. *Id.* § 121. Nonetheless, the benefits of interest-free deferral might distort selling decisions.

\(164\) $100,000 \times (1.5)^4 = 506,250.$

\(165\) This is the excess of the $303,125 average value over the purchase price.

\(166\) $500 + $1250 + $2375 + $12,187.50 = 16,312.50.$

\(167\) \([(3 \text{ years} \times 1\%) + (1 \text{ year} \times 3\%)] \times 4 \text{ years} = 1.5\%.$

\(168\) $203,125 \times .015 \times 4 = 12,187.50.$

\(169\) $(50,000 + 125,000 + 237,500 + 406,250) \times .015 = 12,281.25.$
each year, too little (much) tax results when tax rates are higher in the later (earlier) years. Accordingly, the tax rate choice significantly depends on the gain allocation method. Average tax rates should be utilized in conjunction with an average value assumption. With somewhat less certainty, we recommend actual tax rates in conjunction with a constant return assumption. Although an average rate could soften constant return distortions in certain cases, actual tax rates generally should provide results closer to annual reassessment at actual value. Any administrative advantages from a single, average rate do not appear significant enough to outweigh the substantive advantage of actual tax rates.

4. Transition/Revenue Issues

Transition concerns typically involve the unfairness of rule changes in the middle of the game. By contrast, consider a possible elimination of the federal mortgage interest deduction which raises strong equity concerns since existing homeowners paid more for their homes due to the capitalization of the federal tax subsidy. Our proposal would have a more limited, and appropriate, impact. For clarification, back taxes should be charged only for post-enactment years. Owners with low current assessments would lose the benefits only on a going forward basis, and recall how uncertainty over the duration of low assessments prevents full capitalization of such benefits. Furthermore, unlike the mortgage deduction which reflects government policy of encouraging home ownership, our proposal eliminates preferential treatment unrelated to policy goals.

Consider next possible revenue shortfalls in the interim period due to collection timing differences between the current systems and our proposal. This does not appear to be significant. While substitut-

170 We focus here on maximizing the correlation to value. Unlike the interest charge analysis, value deviations here would not necessarily move the system towards purchase price, which might constitute a desirable alternative norm. See supra Part IV.C.2.

171 Average rates could minimize distortions when constant return allocates excess gain to a high-rate year. We nonetheless recommend actual rates since (1) average tax rates could increase distortions where such excess gain was allocated to an unusually low-rate year, and (2) actual rates work better to the extent actual appreciation follows the constant return pattern.

172 The average tax rate is based on the varying tax rates from prior years.

173 Otherwise, long-term owners would be treated differently depending on whether they sell before or after enactment. Separately, as discussed in greater detail below, the current assessed value could serve as the "purchase price" for homes owned at the time of transition.
ing purchase price for the current assessed values might alter significantly the aggregate tax base, current assessed values could serve as the purchase price for current owners to avoid such shifts. If so, our system generally would not result in a relatively lower base in the immediately succeeding year(s) since most jurisdictions do not reassess annually. And over the long run, the increased tax collections generated by sales—back tax collections from sellers and increased tax base for the buyer—generally should offset the failure to increase the tax base via reassessments. Normal sales patterns should provide a relatively steady revenue stream, at least for larger jurisdictions. Accordingly, any tax rate adjustments should be relatively narrow and short lived.

D. Potential Problem Areas

1. Intergenerational Transfers

Our system, which relies on reassessment on sale, requires a mechanism to deal with properties transferred at death or during lifetime without benefit of sale. Without such a mechanism, clever planners could put off reassessment for generations through a series of gratuitous transfers. Intergenerational transfer of residential homes is not currently the norm in the United States; demographic and mobility patterns ensure that most children will not choose to live

174 Purchase prices could be lower or higher than assessed values, depending on the current system. Adjustments would be necessary for governments which currently assess at a uniform percentage of value. See supra note 16. If assessed values were used as the starting point, back taxes at sale would be calculated based on such assessed value and the sales price.

175 It is possible, of course, that long-term homeowners would agitate for repeal of the proposed system as their potential liability for back taxes approaches. There is, however, a natural check on repeal: the interests of the residents who do not plan to sell in the immediate future. For these residents, who at any given moment should constitute a significant majority of homeowners, repeal would bring a sudden and immediate increase in current taxes.

176 In lieu of tax rate increases, assessments prior to sale could be increased each year by a low percentage, similar to California’s Proposition 13. In addition to possibly smoothing revenue flows, this would reduce the back taxes due at sale, possibly minimizing tax avoidance attempts. We generally do not recommend this adjustment which is more complicated and relaxes possible voting benefits from deferred taxes. We nonetheless highlight the advantages of this adjustment, which might appeal on balance to some localities.

177 The analysis extends to transfers at below-market prices to, e.g., family members.

178 For a discussion of a similar issue under California’s Proposition 13, see supra notes 23–24 and accompanying text.
in their parents' homes. Instead, when homeowners die, most homes are sold, with the proceeds distributed among the homeowner's heirs or will beneficiaries. Our problem, then is two-fold: first, dealing with the small number of cases in which homeowners and their families want to keep homes in the family, and second, assuring that our system does not cause that number to balloon by creating tax advantages for retaining, rather than selling, homes of deceased homeowners.

Perhaps the most elegant solution to this problem is a system of competitive assessment along the lines articulated by Saul Levmore. Upon death of any homeowner, any individuals or corporations with an interest in purchasing the home would be entitled to submit a sealed bid for the home. The homeowner's executor would then be faced with a choice: sell to the highest bidder, or retain the property for the homeowner's family members, with a new assessment set at the bid offered by the highest bidder. If the executor chooses to retain the property, the estate would become liable for the retroactive adjustment ordinarily due upon sale. From that adjustment, the municipality might pay a small commission to the highest bidder to encourage bidding, which in turn increases future tax collections.

The same solution would also be appropriate when a homeowner makes a lifetime transfer for no consideration. Bidders would be free to bid on the home, and the transferee would then have to choose between selling to the highest bidder or retaining the home at the new assessment while paying the retroactive adjustment ordinarily due upon sale. An exemption for transfers to a surviving spouse (both during life and at death)—akin to the marital deduction in the federal estate tax—would assure reassessment at least once a generation, without disrupting the lifestyle of either member of a married couple.

This endorsement of a competitive assessment system raises a natural question: why not adopt the Levmore model for all assessments, thus avoiding all of the administrative costs of the current assessment system while maintaining assessments at current market value? At least three reasons counsel against wholesale adoption of a competitive assessments system, but, as we shall see, none of the three reasons forecloses use of such a system upon death or transfer without consideration.

First, Levmore himself recognized that the competitive assessment system intrudes on a critical stick in the bundle of property

179 Levmore, supra note 115, at 783–88.
180 See I.R.C. § 2056(a) (2000) (codifying estate tax marital deduction); id. § 2523(a) (permitting deduction of gifts between spouses).
rights: the right of an owner to hold out against prospective purchasers who value the property more than the owner does. The competitive assessment process gives bidders the power to coerce sales, and, as Levmore remarks, "[i]t is a small step from forced sales and holdouts to eminent domain." Forced sales and private condemnation threaten to deny homeowners some of the subjective value they attach to their homes.

Second, a competitive assessment system threatens the benefit of the mortgage bargain homeowners make when they purchase their homes. Suppose, for instance, a purchaser buys a home for $100,000 with a 6% fixed rate, thirty-year mortgage in year 2000. Five years later, the market value of the home is $150,000, even though mortgage rates are now 9%. Even if the homeowner attaches no subjective value to the home, the home is worth more than $150,000 to the homeowner simply because the 6% mortgage is not portable. Levmore’s competitive assessment scheme might require the homeowner to accept an assessment of above $150,000 simply to avoid loss of her mortgage bargain.

Third, a competitive assessment system does nothing to ameliorate the moral hazard problem that arises when the benefits of municipal services are not fully capitalized into home price. A homeowner who attaches subjective value to his home, but derives less than average benefit from municipal services, has every incentive to retain his home through the competitive assessment process but to vote against municipal services that might, in the aggregate, generate more benefits than costs.

These problems are far less significant when a competitive assessment scheme is restricted to death and gratuitous transfers. Protecting subjective value is of far less concern to a prospective new owner—even a family member—than to the long-term owner. The family member will not, in general, be entitled to the benefit of the original

181 Levmore, supra note 115, at 789.
182 Indeed, it is this potential loss of subjective value that underlies landowner attacks on government power to condemn land for economic development purposes. See generally Thomas W. Merrill, The Economics of Public Use, 72 CORNELL L. REV. 61, 83–84 (1986) (discussing the potential loss in subjective value associated with exercise of eminent domain power). This power of condemnation was recently upheld by the United States Supreme Court. Kelo v. City of New London, 125 S. Ct. 2655 (2005).
183 Suppose, as Levmore suggested, a municipality offers a commission to winning bidders in order to drive assessments toward market value. If a potential bidder knows that a homeowner enjoys a mortgage (not transferable to any other home) at a below-market rate, the bidder also knows that the homeowner has financial incentives to bid above the home’s market value in order to avoid the risk of losing the favorable mortgage.
owner’s mortgage bargain. And a family member of the original homeowner is less likely to move into the home and area if the municipal package of services does not meet her needs. Finally, the sheer volume of competitive assessments will be far smaller—and any market dislocations less serious—if competitive assessment is used only upon death or gratuitous transfer.

Our proposal does not, however, depend on acceptance of a competitive assessment scheme for intergenerational transfers. A jurisdiction could, instead, conduct a traditional reassessment of property upon death or gratuitous transfer. The number of such reassessments would be far smaller than required under any current scheme, and reassessment upon death or intergenerational transfer would not present the liquidity concerns associated with more broadly based reassessment schemes. Moreover, any imperfections in the revaluation would be rectified, ultimately, upon sale by the next owner, who would pay a higher adjustment tax upon resale. Again, the relevant comparison is with current law, and even if a jurisdiction were to adopt our proposal but conduct traditional reassessments upon death, the evils associated with reassessment practices would be far smaller than under a regime that provides frequent reassessment of all parcels within the municipality.

2. Corporate Entities

When natural persons own real property, transfer or death is inevitable. By contrast, corporate entities might theoretically retain real property forever. Hence, for properties not owned by individuals, our assessment mechanism must make some provision for updating assessments.

The concern is twofold. First, corporate property owners should pay the appropriate tax, and second, individual property owners should not take title as corporate entities simply to avoid reassessment of the property upon death or transfer.

As with intergenerational transfers, a competitive assessment system provides an attractive solution to the problems associated with real property held in the corporate form. Once property is transferred to a corporate entity, the property would be subject to competitive reassessment on a periodic basis, perhaps every five years. At that point, the corporate owner would be required to submit the property for competitive assessment. No further tax would be due on sale.

184 Drawing upon the federal estate tax, any lingering liquidity concerns at death could be addressed by a deferred payment schedule. See I.R.C. § 6166 (2000 & Supp. 2002).


Even more than in the case of intergenerational transfers, the competitive assessment scheme threatens no significant values when the owner is a corporation. By definition, the corporate owner generally attaches no subjective value to the property. Moreover, the corporation does not face the same liquidity issues that might face residential homeowners; if the corporation lacks assets to pay taxes, and if income from the property is insufficient to generate those assets, the corporation can sell the property. Finally, periodic competitive reassessments reduce the incentive for homeowners to shelter property from the property tax by holding the property in the corporate form.  

A municipality could, of course, reject competitive assessment of corporately owned properties in favor of traditional assessment of properties held in corporate ownership. Such a decision would not reduce the advantages of our proposal for properties held in individual ownership.

3. Improvements

The model we have developed so far assumes a homeowner who purchases a home and sells essentially the same home several years later at a somewhat different price. Often, however, a homeowner has made improvements to the house, and some of the increased value reflects the improvements made. How should those improvements be treated for property taxation purposes? In principle, money spent on improvements should be treated equally with money spent to purchase the home. The same competitive reassessment mechanism could be used to deal with all residential housing held by an entity other than a single living individual or two individuals holding property as tenants in common or joint tenants. That is, the competitive reassessment scheme could be used when homes are owned by partnerships, trusts, or co-tenancies comprised of more than two individuals.

The assumption here is that the objective is to tax the value of land and improvements. Starting with Henry George, however, extensive literature has rejected that assumption, arguing instead for a tax on the value of land. Henry George, Progress and Poverty 406 (New York, Robert Schalkenbach Found. 1948) (1879). George argued that a tax focused on land rather than improvements would create appropriate incentives for making land productive:

Everywhere that land had attained a value, taxation, instead of operating, as now, as a fine upon improvement, would operate to force improvement. Whoever planted an orchard, or sowed a field, or built a house, or erected a manufactory, no matter how costly, would have no more to pay in taxes than if he kept so much land idle.

Id. at 437. Even those sympathetic to land-value taxation recognize the practical difficulties in separating land value from value of improvements for taxation purposes.
home should be treated no differently from one who purchases the home for $100,000 and immediately invests $20,000 in home improvements.

This result can best be achieved by adding the cost of improvements to the homeowner’s assessment from the year in which the improvements are made. At sale, the adjustment for increased value would take account of the taxes already paid on the improvements.

Example 5. Homeowner purchases home for $100,000 in year 2000, and makes improvements, at a cost of $20,000, in 2002. Homeowner sells the home for $150,000 in 2005.

Homeowner will pay tax for the years 2001 and 2002 on an assessment of $100,000, and for years 2003–2005 on an assessment of $120,000. Upon sale in 2005, the homeowner will pay an adjustment based on the $30,000 difference between the $150,000 sale price and the homeowner’s $120,000 “basis” (the sum of his original purchase price and the cost of his improvements). Assuming a constant 1% tax rate, the lack of an interest charge, and adoption of the average value method, the homeowner will owe an additional $750 at sale.\(^{187}\)

The difficulties with assessing improvements are not so much difficulties in theory as difficulties in proof. An owner who makes significant improvements to his home has little incentive to report them if the result will be an immediate increase in her tax assessment. Most taxpayers will prefer to defer tax until sale. We address this problem in three ways, reflecting three different types of improvement.

First, for improvements that do not increase the square footage of the house, we would make reporting voluntary, at the option of the homeowner.\(^{188}\) If the homeowner does not report the costs of these improvements, tax would be deferred until sale.

Our reasons for voluntary reporting are twofold. First, many of these “improvements” reflect routine maintenance—repainting, replacing a roof—that every homeowner must complete on a cyclical basis. Little inequity should result if these improvements are subject only to tax adjustments on sale. Second, with respect to interior im-

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See, e.g., DICK NETZER, ECONOMICS OF THE PROPERTY TAX 201 (1966) (noting that absence of market evidence “would make testing of assessment levels and quality virtually impossible in many circumstances”).

187 Homeowner would owe about $843 at sale under the constant return calculation, maintaining the other assumptions. (The annual return is about 4.88%. The values at the end of each successive year would be $104,880; $130,000 (including the $20,000 improvement); $136,350; $143,000; and $150,000. Additional tax would equal $49 + $100 + $163 + $230 + $300.)

188 De minimis improvements should be disregarded.
improvements, any other treatment would encourage evasion of the reporting requirement and would penalize those homeowners who complied with the requirement. Indeed, even under current law, homeowners are not generally obligated to permit assessors to inspect the interior of their homes, and homeowners who have made significant improvements are loath to do so for fear of increasing their tax burden. Our approach improves on current law, because upon sale improvers will ultimately pay tax based on the value of their improvements; under current law, homeowners never pay tax on the value of hidden improvements.189

Second, for improvements that increase the square footage of an existing house, we would require reporting and reassessment, with a presumption that the improvements add value to the property in proportion to the increase in square footage. That is, if a homeowner builds a 500 square-foot addition to a 2000 square-foot house purchased for $100,000, the house would be reassessed for $125,000, unless the homeowner can establish that the cost of the addition was less than $25,000.190

Improvements that increase square footage warrant different treatment for two reasons. First, these improvements have the greatest potential to increase market value. Although remodeling a kitchen or replacing a roof undoubtedly has the potential to increase a home’s value, the potential increase pales in comparison with an addition that doubles or triples the size of a house. Significant increases in size don’t merely improve the house, but transform it into a significantly different house. Second, because improvements that

189 See, e.g., Russell, supra note 119 (noting while major improvements are supposed to trigger new assessment in New Orleans, homeowners “trick the city by getting a permit for minor work while undertaking something more expensive . . . [or fail] to get permits at all”).

190 Without a presumption, a homeowner could evade the reassessment by coming forward with bills that reflect only a fraction of actual cost; because municipal officials have little basis to rebut the homeowner’s figures, the homeowner could realize significant advantage by understating average cost. A shift in the burden of coming forward, and in the burden of persuasion, mitigates this imbalance. The government also should be allowed to rebut the presumption. If not, taxpayers could reduce their taxes at sale by making low-cost square footage additions close to sale. Increased assessment close to sale lowers the tax bill.

Our presumption applies the percentage increase in building square footage to the entire purchase price of the parcel. One might object that this approach ignores the contribution of land value to the value of the parcel as a whole. We offer two responses. First, our presumption is rebuttable by the homeowner, who has an incentive to come forward with evidence of overvaluation. Second, in general, the new square footage is likely to be more valuable, per square foot, than older square footage, offsetting in part any failure to consider land cost.
change square footage typically require a building permit, they are already subject to reporting requirements. Unlike internal improvements, a homeowner is unlikely to be able to hide a second story or a new room. As a result, requiring reassessment is unlikely to penalize homeowners for reporting their improvements.

The third class of improvements is those made to previously vacant land. When a developer builds homes for resale, assessment is not a problem; the home will be assessed at market price as soon as the developer sells the home. When the improvement is not made for resale, but by a contractor who intends to maintain the home for his own use, or for rental purposes, we suggest competitive assessment. Subjective value is not likely to be a problem with a newly constructed home (and the builder can take account of the competitive assessment scheme before building). And a builder who has just invested in a new home is not in a position to express liquidity concerns. As a result, the drawbacks accompanying a competitive assessment scheme do not exist.

**Conclusion**

The property tax remains a cornerstone of local government finance, but no consensus has developed about one of its foundations: how should property be assessed? One group of states, focused on liquidity concerns and protection of long-term residents, has opted for assessment based upon purchase price, ignoring the resulting disparities between tax and property value, and generating incentives for inefficient voting behavior by municipal residents. Another group, focused on horizontal equity concerns, has mandated frequent reassessment of property. These states have overlooked the costs and inaccuracies associated with reassessment, while simultaneously exacerbating the tendency of older and long-term residents to oppose provision of efficient municipal services.

Our proposal, which combines a purchase price approach with a retrospective adjustment upon sale, improves on each of the approaches currently in force. We have presented a number of variations on the basic theme, allowing room for reasonable disagreement on an unresolved question: how closely property taxation should track current market value in order to generate optimal government decisionmaking. We hope and expect that our proposal will generate further discussion and analysis of that understudied issue.