Insight

Housing and Real Property Values

CARLOS BONILLA | NOVEMBER 16, 2011

Since the peak of the housing market in early 2006 the U.S. has experienced close to a one-third decline in home values while state and local governments have seen their property tax revenues increase by 26 percent. Taken together, this comes to an 84 percent increase in the effective property tax rates since 2006, the peak of the housing boom.

An *ad valorem* tax, the property tax is determined by both the rate in effect and the value assigned to the property, and revenues vary accordingly. While state and local governments define the tax in terms of the assessed value, what matters for property owners is the tax as a percent of the market value of the asset, a ratio which has been steadily rising.

A certain amount of this revenue increase even in the face of declining home values is actually normal and to be expected due to a lag in the assessment process. Property taxes in 2007, for example, are based on the prior year's assessments. A more pernicious problem, however, can arise from limits on how much assessments are allowed to rise in a given year, limitsset in place to protect homeowners from drastic rises in tax levies during periods of rapid appreciation. Caps on assessment increases can lead to a gap between the value used in determining the tax and the actual value. Consequently real estate may also have a backlog of "untaxed appreciation" which captures the decline in property values. This will continue until the appreciation backlog is fully reflected in the assessed value, perhaps years down the road. To illustrate this, consider a property with a taxable assessment capped at $500,000, with a market value of $1 million. In the face of a market decline similar to what we have experienced, the property value falls to $680,000. Since this value is still in excess of the previously assessed amount, no decrease in property tax will occur, and may in fact increase.

In effect the states fell victim to the same misconception that ruled the real estate market, believing that prices could only go up and never down and failed to consider how their policies would hurt homeowners in a prolonged downturn. Rather than acting to automatically stabilize the economy in a downturn, they worsened the impact by raising taxes on homeowners who saw their property values decline. The Fair Isaac Corporation's latest quarterly survey of bank risk managers, released September 30th of this year, estimates that a U.S. housing recovery will not take place before 2020. This can't solve itself in the short run from a rebound in property values.

Property tax revenues have risen from 28 percent of all state and local revenues in 2000, to 36.4 percent in 2010. State and local governments often operate under a requirement to balance their budgets, and local governments rely heavily, often exclusively, on property tax revenues. Given the documented collapse in property values, these governments must now diversify their tax bases away from an over-reliance on property taxes.

The financial crisis had its roots in the housing market and the fall in housing values has left consumers wary and anxious to rebuild their balance sheets, a process being hindered by the rise in property taxes even in the face of declining values. Testifying before the Joint Economic Committee, Federal Reserve Chairman Bernanke made the following statement:

Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance, as I have noted today, but a wide range of other policies–pertaining to labor markets, housing, trade, taxation, and regulation, for example–also have important roles to play.

Chairman Ben S. Bernanke, October 4, 2011

The Chairman is right, rebuilding the American economy is a shared responsibility, and it is a role that state and local governments cannot abdicate. The boom in housing values fueled a boom in spending by state and local governments. That spending growth must be reversed to return taxes on real property to historic levels as part of the needed recovery in the real estate market and thus the balance sheets of taxpayers.