Legislative Services Agency

HANDOUTS

Property Taxation Review Committee

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Criteria For Good Proposals for Property Tax Reform
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Suggestions for Agenda Item II: Criteria for Good Proposals

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1. **Make only revenue neutral changes.** Proposals should generate no aggregate (statewide) change in property tax revenues. There would of course be increases and decreases for individual localities.
    a. Arguing against a decrease is the fact that the Iowa already relies less on property taxes than the two other major taxes – income and sales. More important, increasing sales or income taxes in order to decrease property taxes will likely increase the overall tax burden of Iowa taxpayers because property taxes are exported to non-residents to a greater extent than sales and income taxes.
    b. Arguing against an increase is the likelihood that proposals to increase property taxes in the aggregate will face significant political opposition. Proposals to reform property taxes will therefore have a better chance of implementation if they do not entail higher taxes.

2. **Broaden tax base**. Reducing or eliminating existing preferences (exemptions, abatements, TIF) is justifiable on grounds of equity, neutrality, and simplicity.
    a. It will also allow lower average tax rates. This is desirable because the distortions and inefficiencies caused by a tax – whether property, income or sales – increases as the tax rate increases.
    b. At a minimum, proposals should not introduce any new preferences.

3. **Assess at full market value**. To achieve “equal treatment of equals” in the taxation of property, all property should be assessed at full market value.
    a. This would also simplify property taxes and make them easier to administer and collect.
    b. Assessing at full market value would entail eliminating rollbacks.
    c. The change to full market value assessment should be phased in to allow time for adjustment.
    d. At a minimum, no proposal should move the system farther away from full value assessment.

4. **Track value of exemptions and abatements.** Any proposal for reform should include provisions for gaining better information about how the present system operates, especially
    a. reliable estimates of the total value of exempted property and the revenue losses due to exemptions.
    b. revenue losses due to abatements.
    c. funds diverted via TIFs

Following these criteria will preclude any change that narrows the tax base, adds to existing preferences, or provides favorable assessment. This can be thought of as the Hippocratic Oath of tax policy: *first do no harm*. And, as noted above, proposals that meet these criteria are also likely to promote other objectives: horizontal equity, ease of collection, simplicity.

The principles of taxation that support these criteria are discussed in more detail below. Then, I discuss property tax incidence – the question of who bears the burden of property taxes. Finally, I review issues that arise in analyzing the link between taxes and economic development.

Principles of Taxation

While taxation will always be a controversial subject, there is considerable agreement that tax policy should be guided by broad principles, among which the more important are equity, neutrality, competitiveness, simplicity, and predictability.

Equity

Taxes distribute the costs of government among individuals. To be fair or equitable, individuals' tax burdens should be related to their *ability to pay* taxes. Persons with equal ability to pay should bear equal tax burdens – equals should be treated equally. And many would argue that persons with greater ability to pay should bear greater tax burdens – overall tax burdens should be *progressive*.

In the case of income taxation, equal-treatment-of-equals requires that tax rates not depend on how income is received. For example, income from particular types of investment should not be taxed at a lower rate than income from other investments or income from labor. Similarly, for sales taxation equal-treatment-of-equals requires that all *final* sales be taxed at the same rate. That is, a person's sales tax payments should not depend on which products and services she decides to buy. And the case of property taxation, equal-treatment-of-equals requires that the tax levy, as a percentage of market value, not depend on the type of property or where it is located. In short, equal-treatment-of-equals requires that a person's tax burdens not depend on how she earns or spends her income or the type or location of her property.

Neutrality

Virtually all taxes alter economic activity as individuals adjust their behavior in an attempt to reduce their taxes. When tax rates depend on how income is received and spent, individuals will try to reduce their tax burdens by earning lightly taxed forms of income and spending that income on lightly taxed products and services. Similarly, when the tax on properties of given market value depend on where property is located or how it is used, property owners will tend to make *mobile* property investments (structures and improvements) in lightly taxed locations and uses.[1] Lightly taxed economic activities will therefore be expanded at the expense of heavily taxed activities. Such tax-induced changes in economic decisions are ordinarily undesirable distortions of market activity; they are

[1] Mobile businesses can change the location of their operations. For example, a manufacturer of agricultural equipment could operate in virtually any state. In contrast, farming and mining are *immobile.*

barriers to the efficient working of markets. The magnitude of these distortions increases as tax rates increase.

To minimize the distorting effects of taxes, all tax bases should be as broad as possible and all components of each base should be taxed at the same rate. Further, tax rates should be as low as possible, which requires, in turn, *balanced use* of the three major taxes – income, sales, and property. An important exception to these rules arises when relatively high taxes are needed to curtail the use of products that have undesirable side effects on others than the users of the products. An example is the "gas guzzler" tax on large cars, which is imposed to reduce air pollution; another example is the tax on alcoholic beverages, the consumption of which may lead to property damage and loss of life.

Neutrality also requires that taxes not be used to encourage particular industries or types of firms. Reducing taxes for one group of businesses necessarily implies higher taxes for other businesses and individuals or lower public services. Neutrality requires that taxes not be used to manipulate the economy – for example, to try to attract industry. If it is decided, in contrast to this general rule, that subsidies or incentives are justified by market failure, the subsidies/incentives should be provided by direct appropriations in the budget rather than by tax abatements. Then the subsidies and incentives would be a visible and subject to annual review as the budget is prepared.

Competitiveness

The potential influence of taxes on the location of businesses has led to tax competition, whereby states and localities try to use low tax rates to attract businesses. Even if a state does not wish to engage in tax competition, it must nevertheless try to keep its tax rates on *mobile* businesses in line with those in other, particularly neighboring, states. When gauging the effect of taxes on a state's competitiveness, the relevant question is how taxation of *mobile* businesses varies from one state to another. For example, would an Iowa manufacturing enterprise *be able to operate in another state* and if so would it *pay lower tax rates on its income and property in another state*?

This question cannot be answered by comparing broad measures of tax burdens such as the share of taxes collected by property taxes, or taxes as a percentage of personal income, or taxes per capita. More specifically, the fact that property taxes account for a larger share of total revenue in Iowa than in some neighboring states does not mean that *mobile* industrial and commercial enterprises would be subject to higher property tax rates in Iowa than in those states. Neither does it mean that owners of similar residences, say homes with market value of $100,000, would face higher taxes in Iowa than in those states.

Although a state cannot set tax rates without regard for what other states are doing, the importance of taxes in location decisions can be easily overstated. Relatively high taxes may not be a barrier to business if public service levels are also relatively high. Good schools, safe streets, and high quality public infrastructure may offset high taxes. Further, numerous studies show taxes are typically among the less important of the many factors that enter into businesses' location decisions.

Simplicity

Complex taxes are costly for governments to administer and enforce, and they are costly for taxpayers to comply with. Taxpayers incur compliance costs as they keep records, file tax returns, and make tax payments as called for by tax laws. Administrative, enforcement, and compliance costs increase with the number of taxes imposed and the complexity of those taxes. Base broadening is the most effective means of reducing these costs. It does so by eliminating the complex rules and distinctions needed to implement the exemptions, deductions, and credits that narrow tax bases.

Predictability

Taxes affect the profitability of investments, many of which are tong-term, requiring a commitment of resources for years, if not decades. Having a stable tax system would make it easier for businesses to predict future taxes, thereby facilitating planning for long-term investments. In contrast, the current practice of introducing major tax legislation in virtually every session of the Iowa General Assembly complicates business planning.

Property Tax Incidence

Property taxes are collected from property owners. The burden of Iowa property taxes is therefore *initially* on the owners of Iowa property. This initial distribution of tax burdens is termed the *impact* of the tax. The ultimate distribution (*incidence*) of burdens will differ, however, from this initial distribution. That is, property tax burdens may be shifted to individuals other than the owners of the property on which the tax is levied.

Shifting occurs when property taxes lead either to higher prices of goods produced with property or to lower incomes for labor and other resources employed in the production of those goods. In the first case, burdens are shifted to buyers (consumers) of goods produced with property; in the second, burdens are shifted to resource owners. The latter occurs, for example, when taxes on a factory's buildings and equipment result in lower rents for owners of the land on which the factory is located or lower wages for factory employees.

The extent of shifting varies by type and use of property. Shifting results from the adjustments that owners of mobile capital make in response to the tax.[2] Therefore, shifting does not occur if property owners cannot adjust the use or location of their property in response to the tax, or if they do not find it profitable to do so. For this reason, there is general agreement that taxes on land are not shifted, and that taxes on agricultural property do not lead to higher prices for agricultural products. There is likewise agreement that on taxes owner-occupied residences are not shifted; because individuals are at the same time landlords and renters, taxes cannot be shifted forward in higher rents.

Taxes on other classes of property (commercial, industrial, and utility) may be shifted in varying degrees. For example, forward shifting of taxes on utility property is likely because the product is obtainable only from the local producer and the demand for the

[2]Among types of property, land and natural resources (e.g. mineral deposits) are *immobile*. In contrast, reproducible property (buildings, equipment, and other improvements) is *mobile* in the sense that the amount of such property within a taxing jurisdiction can *over time* be increased or decreased in response to property taxes. Reproducible property can therefore be retained within a jurisdiction only if its owners realize an after-tax return that is competitive with what they could earn elsewhere.

product is not highly responsive to price. To the extent that taxes on commercial and industrial property are not shifted forward, they are borne in some combination by employees of the taxed enterprises, owners of land used by the taxed enterprises, and all owners of capital (property). Taxes on the land component of industrial and commercial property are, as explained above, not shifted and are therefore borne by landowners.

There has long been uncertainty and debate about the shifting and incidence of property taxes, especially those levied on commercial and industrial businesses. There is, consequently, no universally agreed on answer to the question: Who bears the burden of property taxation? However, there is agreement that taxes on agricultural property and owner-occupied residences, which account for a large share of Iowa property taxes, are not shifted. Some fraction of the remaining classes of property is land, the taxes on which are likewise not shifted. It is therefore quite unlikely that more than one-half of the taxes levied on Iowa property are shifted from property owners.

Property taxes, whether shifted or not, may be borne by nonresidents as well as resident Iowans. When taxes are borne by nonresidents, they are said to be *exported*. Taxes that are not shifted may be borne by nonresident owners of Iowa property. When shifted forward, taxes may be borne by nonresident buyers of goods and services produced with Iowa property. When comparing the incidence of Iowa's major taxes (income, sales, and property), it is important to take into account how they differ in the extent of exporting – property taxes are exported to a greater degree than either sales or personal income taxes. Consequently, when the sales tax or the personal income tax are increased to provide property tax relief, the overall tax burdens on resident Iowans will increase because the exported share is greater for the property tax than for the income and sales taxes.

Property tax capitalization

Property taxes decrease the net (after tax) income accruing to owners of land, buildings, and other taxable real property located in Iowa.[3] This decrease in income tends to be capitalized into the market value of immobile property – principally land. That is, when property taxes on land are increased, land values fall by the *present value* of the current and expected future increases in property taxes. Similarly, land values increase when property taxes are decreased. As a result of capitalization, current owners of land bear the burden of any *increase* in the taxes that they (and any prospective buyer of land) expect to be levied on the land in the future. Changes in taxes that are expected to persist into the future generate windfall gains and losses for *current* owners of land -- gains if expected taxes decrease and losses if they increase. Capitalization has important implications for equity of *changes* in taxes, credits, and exemptions. For example, to the extent that current property taxes on land were accurately foreseen at the time present owners acquired the land, the present owners bear none of the burden of the property taxes being currently collected. Furthermore, reducing those taxes (through an increase in credits) would generate windfalls for current owners.

[3] This is the effect of the tax taken alone. To the extent that the tax pays for services that directly benefit property owners, net income need not be reduced.

Taxes and Economic Development

Iowa's political leaders understandably want to promote economic development, especially in a period of budget shortfalls and sluggish economic growth. They see tax policy as one lever that can be used to boost the economy. What are the pros and cons of using taxes in this manner? To answer this question, we need to be clear on what is meant by economic development.

Economic development defined

The purpose of economic development is to increase the economic welfare of resident Iowans – the constituents of Iowa governments. Economic welfare increases when income and wealth increase. That is why we used increases in income and wealth, *both broadly defined*, as the primary goals of economic development. Put differently, ***we would not want to say that a policy promotes economic development if it reduces the income and wealth of Iowans as a group***.

Simply increasing the number of people in Iowa or the number of businesses located in Iowa or the total production of those businesses does not in itself represent economic development. Having more people or more businesses makes Iowans better off only if it increases their income or wealth. Surely, politicians would not want to implement a policy to attract businesses or population to Iowa if it reduced the income or wealth of Iowans.

It is of course possible that a policy could increase income or wealth for Iowans as a group, but leave some Iowans worse off. That is, there could be winners and losers. But in this case, the gains of the winners should be greater than the losses of the losers; otherwise the policy makes Iowans worse off in economic terms.

Income defined

Iowans' income is the value of the flow of goods and services available to them to meet their on-going needs. These goods and services are in part purchased in the market place, so Iowans' income increases when they receive higher wages, dividends, interest, profits, etc. from working and investing. But Iowans' also get goods and services from government, so their income also goes up when government supplies better education, roads, public safety, etc.

Wealth defined

Iowans' wealth increases when the value of privately owned assets – land and natural resources, residences, factories, stores – increases. Their wealth also increases when the value of their public assets – parks, hospitals, schools, etc. – increases. And the value of both private and public assets my increase (decrease) when the quality of the environment increases (decreases). For example, cleaner rivers and streams make land and buildings along those streams more valuable. Cleaner air within a city adds to the value of the land, residences, and business buildings within the city.

Instrumental objectives

The basic objective of economic development is to increase income and wealth. Indeed, economic development and increases in income and wealth are generally regarded as one and the same. We measure a nation's economic development by the levels of income and wealth that its citizens enjoy.

Political leaders often identify other objectives or goals of economic development policy, such as encouraging entrepreneurial activity; increasing competitiveness for mobile high-wage workers and mobile physical capital, and diversifying the economic base. But these should not be regarded as fundamental objectives of development policy; they are instead instrumental objectives. ***We want to achieve these objectives only if in doing so we would increase income or wealth.*** If we assert that being competitive in attracting workers and capital promotes economic development, we must be able to explain how that adds to income and wealth of Iowans.

Why tax changes may have small effects

When taxes are reduced for one group of taxpayers, taxes must be increased for other taxpayers or government spending for some purposes must be decreased. Reducing taxes for one group of taxpayers ***necessarily*** entails other changes that may adversely affect Iowans' income and wealth. Changes in tax law therefore entail complicated and ***potentially offsetting*** effects on economic development, with the result that ***the net effect is small, uncertain, and difficult to estimate.***

For example, to gauge the effects of switching from a graduated to a flat income tax rate structure, we cannot focus solely on possibility that a flat rate may give higher income persons an incentive to move to or stay in Iowa. We must also take account of the adverse effects of having either ***higher taxes*** for lower income taxpayers or ***lower government spending*** for education, public safety or other government services. The ***net*** of these ***positive and negative*** effects on Iowans' income and wealth is what we must be concerned with. This net influence is plausibly small and uncertain. And it could be negative; if the shift to a flat rate results in poorer schools and less safe streets, Iowa could even be made less rather than more attractive to high-income persons. This is one reason why we did not attribute significant economic development effects to tax law changes.

There is another perhaps more important reason for thinking the effects are likely not significant. Taxes are a relatively small part of most businesses' costs. For most businesses, labor, materials, and energy costs are greater than taxes. So when we reduce a ***small component*** of cost by a ***small fraction***, as most policies do, we should not be surprised that it would have a ***small effect*** on business decisions. Any decrease in taxes on some businesses must be accompanied by higher taxes on other businesses or persons or lower government services. The ***net*** effect on income and wealth of these ***small effects, both positive and negative,*** will likely be small and uncertain.

A third, simple reason why cutting taxes may not increase Iowans' income and wealth is that the favored taxpayers may not all be Iowans – ***the tax cut may be exported in part to nonresidents!*** This would be the case for lower taxes on agricultural, industrial, and commercial property, since some of that property would be owned by nonresidents. Similarly, lower taxes on Iowa corporations may accrue to nonresident shareholders of those corporations. And because many Iowans deduct their Iowa income taxes in calculating their federal taxes, decreases in Iowa's personal income taxes are partially offset by higher federal income taxes.

Are there any tax policies that would promote development?

Can Iowa promote development by taxing some products and activities and using the proceeds 1) to reduce taxes on mobile capital and labor or 2) to provide other incentives to attract businesses? Perhaps. The state could try to increase taxes that would not cause people and businesses to leave Iowa and use the revenue to finance subsidies in the form of lower taxes, low cost loans, research facilities, business incubators, infrastructure investment, etc. for mobile businesses. This is an "If you pay them, they will come (or stay)" policy.

Examples of taxes that might be increased without having an unfavorable effect on business location are taxes on land, excise taxes on tobacco and alcohol, and sales taxes on currently untaxed services. (Note that taxes on land that are independent of the use of the land will not change how the land is used. Such taxes will be capitalized into lower land prices.)

But we must recognize that even if such a policy succeeds in attracting businesses that would not otherwise locate in the state, the end result would not be economic development unless Iowans' income and wealth is thereby increased. Let's tally the potential effects on Iowans' income.

Sources of gains in income:

1. Income of the persons investing in businesses attracted by this policy would presumably be higher. But their gain in income would be ***at most*** the amount or cost of the subsidy since the businesses presumably would not have located in Iowa without the subsidy.
2. The subsidized businesses may employ workers at higher wages than they could get elsewhere. (Note that the gain to workers is not the full amount or their wages, but only the amount in excess of what they could get in their best alternative job.)
3. State and local governments may collect additional taxes.

Offsets to income gains:

1. Potentially offsetting these gains in income are the higher taxes required to finance the subsidies.
2. Some of the gains could accrue to out-of-state investors in the subsidized businesses.
3. Although governments are collecting more taxes from the businesses, the higher level of business activity may generate costs for government – police and fire protection, road construction and maintenance, traffic control, sewage collection and treatment, waste disposal

Whether development occurs is therefore a question of fact that must be answered on a case-by-case basis. And once estimated, the gains (or losses) due to the policy may be small for reasons discussed above.

Tax breaks or subsidies to attract businesses to Iowa can, of course, be financed by borrowing or by reducing government spending. Do these possibilities change the above conclusions? No, because as noted above, lower spending has potentially adverse effects on Iowans' incomes. And borrowing entails either higher taxes or lower spending in the future, both of which may have adverse effects that partially or fully offset any gains from attracting businesses to the state.

Finally, these policies are ***necessarily re-distributive***, taking from one group of Iowans and giving to another. The question therefore arises: Is such redistribution fair?