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Economic Implications of Florida's Proposed Property Tax Amendment

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On January 29, Floridians will vote on a proposed constitutional amendment to reform the state's property tax system. The two main features of the reform are making the tax benefits conferred by the Save Our Homes (SOH) provisions of the Florida Constitution portable and doubling the homestead exemption to $50,000.[1] Of the two, the second will not apply to property taxes levied for school purposes. This proposal arose in response to widespread and growing dissatisfaction with the state's current system of property taxation as house prices appreciated rapidly from 2000 to 2006.[2] Generally, taxpayers' dissatisfaction takes one of four forms which may be summed up as follows:

1. Taxes are generally too high.
2. Taxes for some homeowners are too high relative to those for other homeowners.
3. Taxes on business owners, including taxes on rental units (which are passed on at least in part to renters), are too high.
4. Some homeowners who would otherwise like to move don't because they would lose their Save Our Homes protection and face prohibitively high taxes on their newly acquired homes.

[1] This is a simplification of the proposal, which would exempt assessed value between $50,000 and $75,000. The amendment would also cap annual growth in the assessment of all not-previously-capped property at 10%. This cap would not apply to school taxes. Finally, it would grant an exemption of $25,000 for tangible property, such as business equipment and office furniture. We do not discuss these new homestead and business exemptions or the cap because we feel that they are of very minor importance compared to the portability provision.

[2] See, for example, the *Bradenton Herald* editorial on January 20, 2008, endorsing the new proposal. Available online at http://www.bradenton.com/opinion/story/340336.html; accessed January 21, 2008. See also, "Poll: Affordable States Tempting to Floridians," *St. Petersburg Times*, October 27, 2007.

Unfortunately, the proposed reform will have no impact on the first concern and will seriously exacerbate the second and third problems, while ameliorating only the fourth.

Florida's Property Tax System

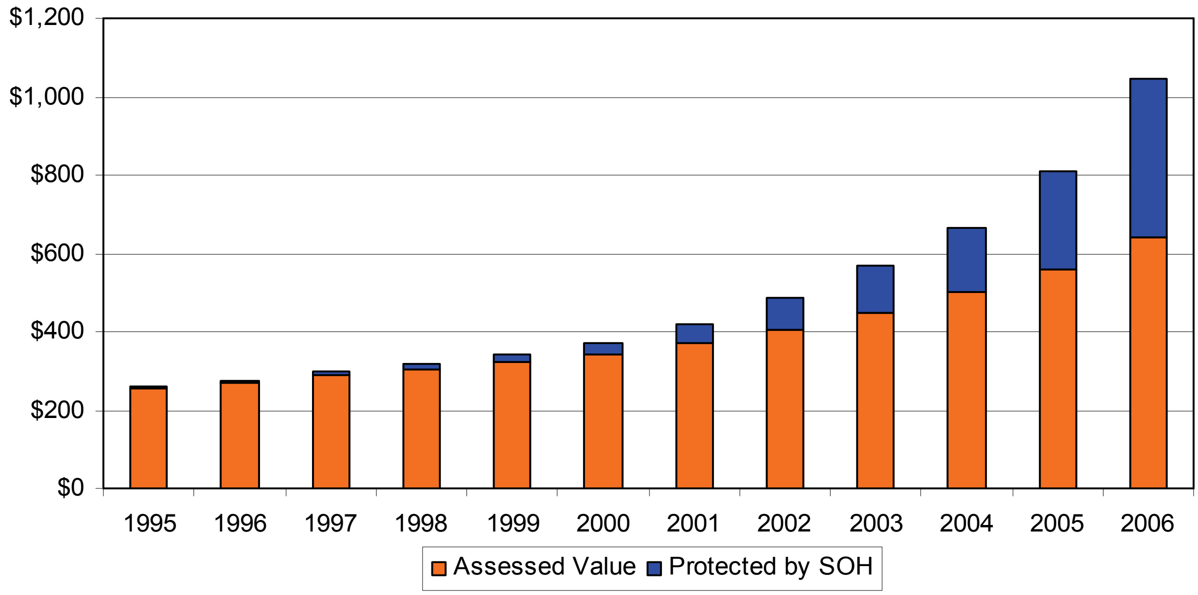
In order to understand the effects of the proposed amendment, we must first consider how the property tax system currently works. A homeowner's property tax bill is determined by the relevant tax rate and the property's taxable value. The first is measured by the millage rate, which is set by the taxing authority, subject to two important constraints. First, millage rates for school, county, and municipal purposes cannot exceed 10 mills each, except in certain circumstances and with special approval. Second, legislation passed in 2007 caps millage rates, except with special approval, at a level allowing tax revenue to grow no more than in proportion to per capita income and new construction. A property's taxable value is set annually by local tax assessors, who also determine its just and assessed values. The just value is an estimate of the fair market value of the property. The assessed value for a homestead is equal to its just value in the first tax-year of the homeowner's residence in the property, but SOH limits its growth rate in subsequent tax-years to the lower of 3% or the rate of inflation. The $25,000 homestead exemption is then deducted from assessed value to obtain the property's taxable value, to which the millage rates established by local governments are applied.[3] The taxable value of non-homestead property (such as apartments and land used for industrial or commercial purposes) is found by subtracting any special exemptions for which the property may qualify from its just value.

The effect of the SOH cap, in the context of the recent boom in house prices in the state's major metropolitan areas, has been a yawning and growing gap between homestead just and taxable values. This gap, which we call the SOH benefit, rose from $3.5 billion in 1995 to $404.4 billion in 2006 and represents a 40% reduction in the property tax base relative to what it would have been in 2006 without SOH. (These developments can be seen in Figure 1.) The proposed constitutional amendment would change the current SOH regime by making homeowners' SOH benefits "portable" when moving from one homestead to another in the state. Thus, instead of incurring the full brunt of a large jump in tax liability as the new homestead's assessed value resets to its just value, as is currently the case under SOH, homeowners would be able to transfer all or part of their previous SOH benefits to a new homestead.[4]

[3] There are various additional exemptions for residents over the age of 65, but these are minuscule next to the main homestead exemption.

[4] This transfer would be on a dollar-for-dollar basis if the new property is of equal or greater just value than the old, or on a proportional basis otherwise.

Figure 1. Homestead Property Tax Figures, 1995–2006 (in billion of dollars)



Note: Column height represents statewide homestead just value.

Source: Tables 3 and 4, "Florida's Property Tax Structure: An Analysis of Save Our Homes and Truth in Millage," Florida Department of Revenue, November 15, 2006, Draft.

Taxes are Generally too High

State and local governments face a budget constraint, in that expenditures cannot exceed tax revenues. Even debt encumbered for capital projects must be serviced and retired. Over time, we might expect government expenditures to grow at the same rate as that of total income and its two components, population and per-capita income, as larger and richer populations might respectively want more and better parks or libraries.[5] Since an individual's property tax bill is the product of the millage rate and his property's taxable values, it makes sense for millage rates to fall during periods when property values (and thus assessed values) grow faster than total income. Instead, from 2000 to 2006, taxes and expenditures increased faster than incomes. So it is not unreasonable for taxpayers to argue that taxes should be limited, but it must be kept in mind that this is the same as saying local government should spend less on services like schools and police. Each individual has priorities for which services to fund, and we can expect that the decision on which services to cut to be more contentious than the decision for a reduction of taxes.

The proposed reform will indeed shrink the future tax base relative to what it otherwise would have been. But it will have little to no impact on total property tax collections or expenditures. First, in the long run, and for most

[5] This is an accurate description of how local government expenditures have grown over time. See Section IV (especially Figure IV-21 on p. 122), "Analytical Services Relating to Property Taxation, Part 2: Revenue Component," September 21, 2007 (revised). Available online at http://edr.state.fl.us/property%20tax%20study/property%20tax%20study.htm

taxing authorities, the increase in the homestead exemption will have little impact, amounting to about 4.4% of the total taxable property value in 2007.[6]

Second, since portability will extend the lifetime of current SOH benefits, its introduction will reduce the tax base and slow its subsequent growth relative to what it would have been. However, the taxable value of all SOH capped property will continue to grow at the lower of inflation or 3% annually. Further, enough new property tends to be added to the tax roll to increase aggregate taxable value at the rate of growth of income, even if the taxable value of *all* existing property could not appreciate faster than inflation.[7] So, aggregate taxable value will still grow fast enough to support growing public expenditures in most of Florida's taxing districts and for most years.

Third, even in those taxing districts or for years where portability constitutes an effective limit on tax base growth, the taxing authorities can raise millage rates enough to increase expenditures at the rate of growth of income anyway, preventing aggregate property taxes from declining. Taxing authorities that are already at the millage limit would have been constrained without portability. We will also see increased state assistance to the localities most affected by the proposed amendment. Therefore, except for small short term adjustments, the impact of the proposal on aggregate tax collections and expenditures will be essentially zero.

Although we expect portability to have only a negligible effect, beyond minor initial adjustments, on overall property tax collections, its introduction may have an unexpected and paradoxical effect on the property tax bills of some homeowners. Consider what may happen as residents from counties that have experienced more rapid house-price appreciation (typically southern and coastal counties) acquire less expensive homesteads in counties with slower house-price appreciation (like those in the interior and north of the state). Even after being prorated to reflect the lower house prices of their new homesteads (as provided in the proposal), the movers' SOH benefits may represent a higher portion of just value than those of long-time residents, eroding the local tax base more quickly than the state average. In order to generate sufficient revenues, such local governments may respond by raising millage rates, offsetting at least partially the benefits to local homestead owners from the proposed constitutional amendment's higher homestead exemption.

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[6] This follows from the fact that there were about 4.4 million homestead properties in 2007 with a statewide taxable property value of $2.5 trillion. Multiplying the new $25,000 exemption by 4.4 million, and controlling for the fact that some properties have a current taxable value of less than $25,000, we find the new exemption would reduce the tax base by slightly less than $110 billion.

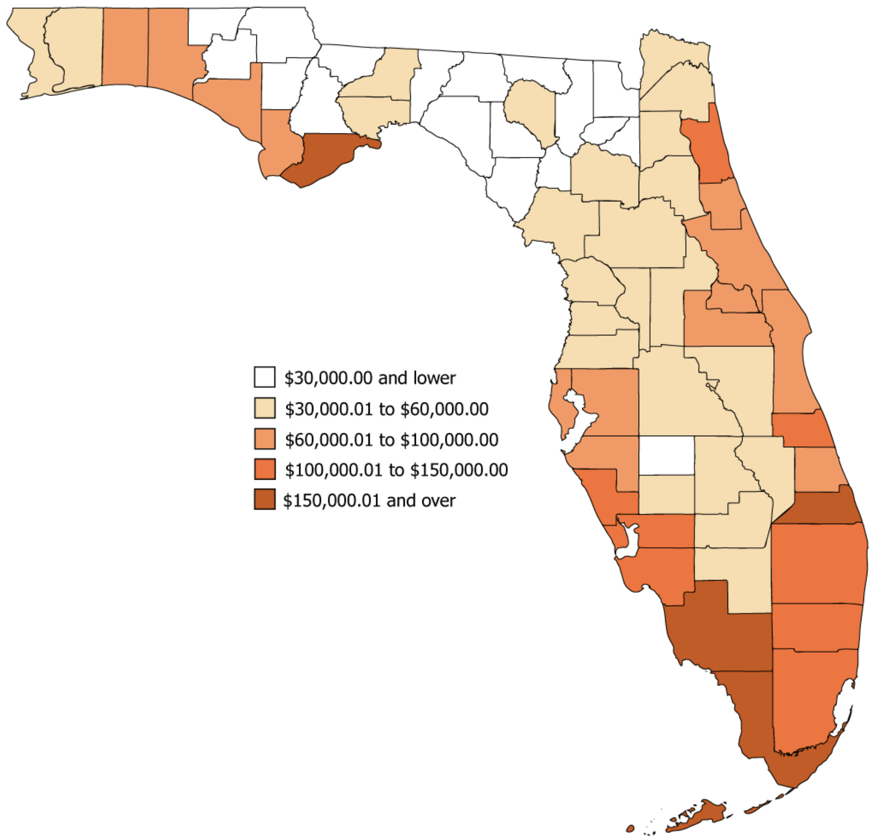
[7] See Section II.4, "Analytical Services Relating to Property Taxation, Part 2: Revenue Component," September 21, 2007 (revised). Available online at http://edr.state.fl.us/property%20tax%20study/property%20tax%20study.htm

Some Homeowners' Taxes are too High Relative to Others'

Whether a tax system or a change to it is fair, like all matters of fairness, is a subjective question. Nevertheless, we feel that two generally accepted criteria of equity are relevant to the portability proposal. The first, which we call horizontal equity, is that the tax system treat people in similar situations in a similar manner, and it has long been apparent and widely known that the current SOH regime fails in this regard. Consider the hypothetical case of two homeowners, Mr. Smith and Ms. Jones, both lifelong residents of the state and both of similar family and economic situations. If Ms. Jones has lived in her house in an area of rapid house-price growth for the past twenty years, her SOH benefit would be very large. Suppose Mr. Smith moves next-door to Ms. Jones. Under the current tax system, due to past house-price appreciation, the assessed value of his house would be reset to its just value, so Mr. Smith's tax bill would be significantly higher than Ms. Jones'. An extension of this inequity is that owner-occupiers of condominiums benefit from the SOH caps and the homestead exemptions, while renters, who represent roughly 30% of the state's households and who pay property tax as part of their rent, do not.

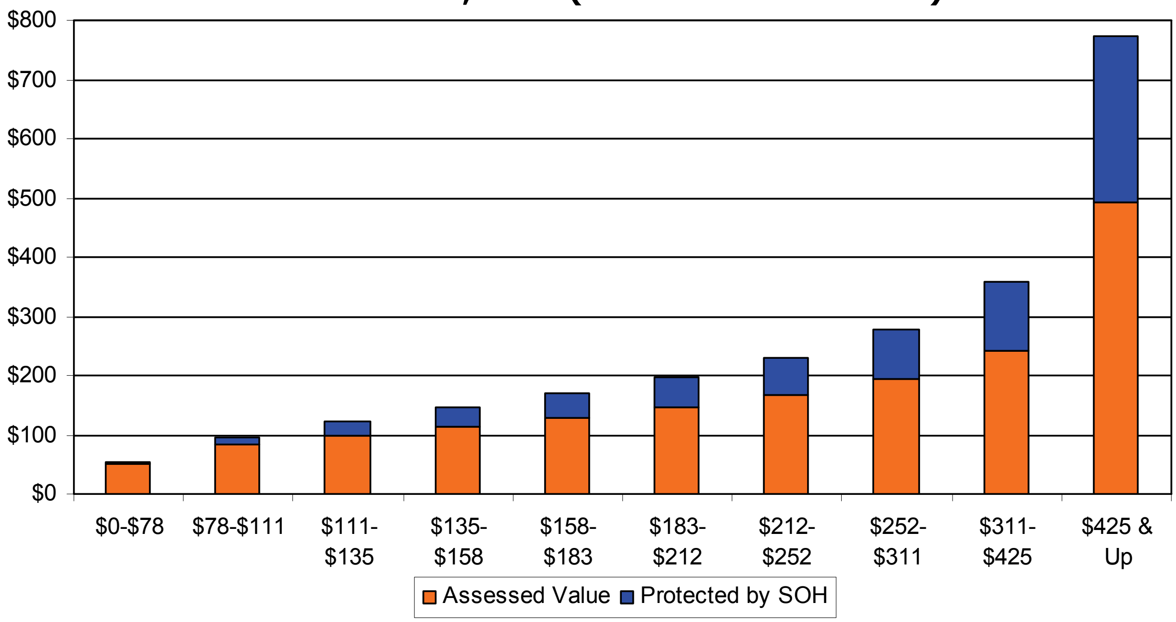
The second equity criterion, called vertical equity, is that the tax system not particularly harm residents and regions with lower levels of wealth or income. SOH fails in this regard, too, but in a subtler way. The decade-long streak of unprecedented house-price appreciation has represented an expansion of household wealth across the state, but the growth in household wealth has been uneven among Florida's regions. This can be seen in Figure 2, which presents average county SOH benefit. In contrast, the SOH cap, which reduces the amount of wealth that is taxable, is applied uniformly. This has meant that the tax-break provided by SOH is largest where appreciation and property values have been highest. Specifically, the most valuable 30% of homesteads account for 58% percent of the just value of all homesteads and received 68% of all SOH benefits in 2006. Figure 3 shows the average just value and average SOH benefit by deciles of homestead just value. Since millage rates must rise to maintain any given amount of revenue as the tax base contracts, those with the smallest SOH benefits, who also own the least valuable homes, actually have *higher* property tax bills than they would have in the absence of SOH.

Figure 2. Average Amount of Homestead Just Value Protected by SOH, 2006



Source: Tables 2 and 41 of Part IV, 2006 Florida Property Valuation and Tax Data, Florida Department of Revenue, June 2007.

Figure 3. Average Homestead Property Valuation by Decile of Homestead Just Value, 2006 (in thousands of dollars)



Source: Authors' calculation based on Florida Department of Revenue 12.D590 Name/Address/Legal File.

One major extension of both the horizontal and vertical inequities of SOH occurs through the Florida Education Finance Plan, which funds public K-12 schools. While property taxes for schools are collected locally, the required local effort millage rate is set by the state to be essentially equal across counties. But current SOH benefits are concentrated among homeowners where house-price appreciation has been the highest (typically in counties that are southern and coastal and more affluent relative to the state average.) Since the required local effort millage rate must be higher to raise a given amount of revenue for schools, SOH results in an effective *increase* in property taxes paid by taxpayers living in counties that are more northern, interior, or less affluent relative to the state average.

With the currently flat housing market and the assumption of a more moderate rate of future house-price appreciation, the current SOH system allows these inequities to diminish as homestead property owners move. Portability, which does not alter the fundamental nature of SOH but instead perpetuates the current high and uneven distribution of SOH benefits, will significantly exacerbate these equity concerns.[8]

One final inequity is that portability benefits only those residents who decide to move within the state. The far greater number of taxpayers, those who wish to live in their current homes over a period of years or a decade or more, will receive no additional benefit from portability. Further, since millage rates will have to increase to make up for the increased persistence of SOH benefits due to portability, most homeowners will see their school property tax bill actually *increase* due to the reform relevant to what would happen without it. Homesteaders who do not move will see their county and municipal property tax bills lowered by the doubling of the homestead exemption on the one hand, but, on the other, that reduction will be offset by increases in millage rates. The result will be an increase in total property tax bills for many owners of homestead property and for all owners of non-homestead property.

The Share of Property Taxes Borne by Business is too High

Tax systems distort decisions in an undesirable way when they cause lower valued alternatives to be chosen over higher valued ones solely because of a more favorable tax treatment. This results in a social loss, or inefficiency. Florida's property tax system, particularly SOH, distorts property-use decisions. This is because SOH reduces the tax burden of owner-occupied residential property, causing the other constituents of the tax base—especially rental and commercial property—to shoulder heavier taxes as millage rates

[8] The difference in treatment between new and long-time state residents may also open portability to court challenges on the grounds of violating the U.S. Constitution's Privileges and Immunity Clause. For a detailed analysis of legal issues surrounding portability, see Legislative Office of Economic and Demographic Research, "Florida's Property Tax Study Interim Report," February 15, 2007. Available at http://cdr.state.fl.us/property%20study/Ad%20Valorem%20report.pdf. See especially pp. 114-123.

rise to maintain local services. The effects on firms and entrepreneurs, while not necessarily inequitable, are important to consider.

Because portability of SOH benefits will impose further constraints on the growth of the homestead component of the tax base, it will require higher millage rates to raise any given level of tax revenue. Therefore, portability will most likely cause an *increase* in Florida's already high business taxes. This will further dull Florida's competitive edge in export-oriented industries. We are not suggesting that special treatment be given to specific sectors or businesses; indeed, we think that such policies are often ill advised and, taken from a national perspective, often counter-productive. Rather, our goal is to ensure our fellow Floridians understand the importance of tax policy on the business environment. There is nothing wrong with a service-oriented economy directed towards local consumption. We feel, however, that there are definite benefits associated with having a technically-oriented sector in the state economy with an emphasis on export-production, which is already one of the state's explicit goals. In our opinion, portability of SOH benefits will undermine progress toward that goal.

Firms have a choice of where in the United States, and increasingly where in the world, to do business, and they will avoid Florida if their competitors reside in lower-tax jurisdictions. While Florida is generally perceived as a low-tax state, it is a high-tax state from the viewpoint of businesses.[9] Florida's higher business taxes impede the growth of firms that are not oriented exclusively toward provision of local services, since they and their competitors are free to locate in lower-tax states. Some such firms, especially those with a technical or scientific focus, may demand special tax-breaks or infrastructure commitments to begin operations in the state. Even firms such as booksellers and clothiers increasingly feel the pinch from Internet-based competitors that often charge no sales tax and avoid the property taxes required of location-based "brick-and-mortar" businesses. Moreover, to the extent that tax burdens cannot be passed on to consumers, the higher levies on commercial properties may discourage the opening of supermarkets, restaurants, and other establishments that serve the local market.

SOH Currently Locks Homeowners into Their Present Homes

SOH as it stands now distorts the decision of whether and when to relocate within the state because the tax benefit it provides is lost if a homeowners moves. In what we call the "lock-in effect," SOH "locks" homeowners into their current homes and punishes those who move at all,

[9] In an analysis of state and local business taxes by Ernst & Young, Florida was found to collect 5.4% of its gross state product in business taxes, higher than most of its peers in the South and higher than the national average of 5.1%. Robert Cline, Tom Neubig, and Andrew Phillips. "Total State and Local Business Taxes," February 2007. Available online at http://www.ey.com/global/assets.nsf/US/Total_State_and_Local_Taxes_-_50_State_Estimates_2006/$file/TotalStateLocal Taxes 2006.pdf; accessed January 18, 2007.

even within the state.[10] In previous work for the Legislature, we estimated this effect to cost Floridians around $9.6 billion annually.[11] We now have some reason to believe that estimate is too high, but we remain confident that the effect is sufficiently large to warrant attention. Portability would lessen the lock-in effect by reducing the potential increase in property tax accompanying a change in homestead. In this regard, then, portability could improve the efficiency of the state's property tax systems. We are doubtful, however, that this improvement in efficiency would be as large as the loss of efficiency due to increasing the tax burden on businesses.

Will Portability Stimulate the Economy?

Given Florida's current economic slump, proponents of the proposed amendment may claim that it will stimulate the economy in general and the housing market in particular in two ways. First, they may claim that a reduction in property taxes, due to the increased exemption and portability, will boost disposable incomes and thereby increase consumer spending. We have shown, however, that the amendment will not significantly reduce total property tax collections, even if it does lower the taxable values of some homestead properties. Furthermore, the increased exemption and portability together will instead increase effective property taxes on businesses during or at the end of an economic downturn.

The second claim is that portability will allow those who are currently "locked in" to their homes to move, further stimulating the economy, especially the housing market. However, it takes time to plan and execute a move to another home. By the time most of those who are currently "locked in" their homes actually move, the short term economic slump will probably be over. Moreover, the state's gross economic output will increase by exactly the value of the increased commissions paid to real estate agents when formerly "locked-in" Floridians sell their homes, reflecting the value of improved matching between homes and owners. Since those Floridians, had they not moved, would have spent the money paid in commissions on goods and services for themselves, the increase in measured state economic output due to reducing lock-in cannot exceed the monetary value of real estate commissions on these additional home sales.

Conclusion

We cannot pretend to have given a thorough investigation in this *Florida Focus* of such large and difficult topics as SOH and the proposed introduction of portability. We have instead tried to provide a brief overview of the major issues relating to the proposed amendment so that Floridians may be better able to evaluate the potential effect

[10] This is also an efficiency issue, since it causes economic choices in housing made by residents to be less efficient than they otherwise would have been.

[11] See Section IV, "Analytical Services Relating to Property Taxation, Part2: Revenue Component," September 21, 2007 (revised). Available online at http://edr.state.fl.us/property%20tax%20study/property%20tax%20study.htm

on their long-term financial interests and on the state's property tax system.

Floridians' grievances with the current property tax system generally take one of the following forms:

1. It leads to total tax collections that are generally too high.
2. It creates inequity across homeowners based on the length of ownership and region of residence, providing generous tax-breaks to homeowners in southern and coastal regions and small tax-breaks or possibly even effective tax-hikes to those in the north and interior of the state.
3. It imposes stiffer duties on Florida's businesses and dampens the development of export-oriented activities.
4. It locks homeowners into their current homes by presenting them with substantially higher tax bills should they move to new homesteads.

Our analysis has shown that the proposed amendment will have very little impact on total property tax collections, exacerbate inequities among homeowners and other residents, and lead to higher effective taxes on businesses. While it will encourage homeowners who are "locked in" their current homes by SOH to move, this benefit is not likely to outweigh the costs of higher business taxes and greater inequity.

Though the proposed constitutional amendment is packaged as tax relief, it is more accurately described as a shift in the distribution of an unchanged overall tax burden. It will shift more of the tax burden to those with homes of moderate value that have appreciated modestly, renters, residents of northern, interior, or bedroom counties, and owners of businesses and rental property. This shift will be to the benefit of homeowners in affluent, southern, or coastal counties whose properties have become very valuable in recent years through rapid appreciation, and those who plan to move soon.

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