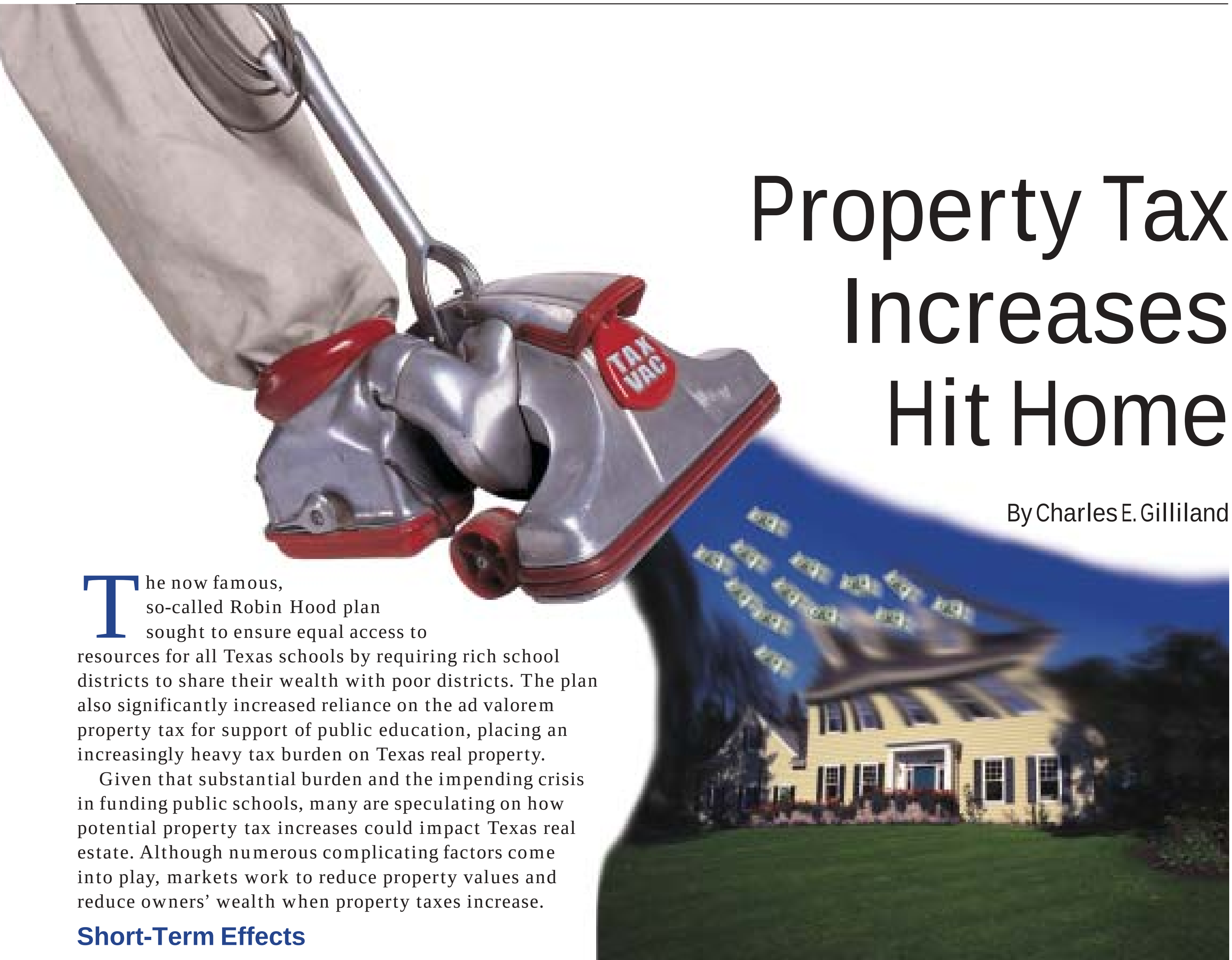
A Reprint from *Tierra Grande*, the Real Estate Center Journal



Property Tax Increases Hit Home

By Charles E. Gilliland

The now famous, so-called Robin Hood plan sought to ensure equal access to resources for all Texas schools by requiring rich school districts to share their wealth with poor districts. The plan also significantly increased reliance on the ad valorem property tax for support of public education, placing an increasingly heavy tax burden on Texas real property.

Given that substantial burden and the impending crisis in funding public schools, many are speculating on how potential property tax increases could impact Texas real estate. Although numerous complicating factors come into play, markets work to reduce property values and reduce owners' wealth when property taxes increase.

Short-Term Effects

Assessment and collection determine the first impact of the property tax. Some owners appear to be able to avoid the negative effects of the tax by passing the cost along to the end users of the real estate. For example, landlords can raise rents and developers can boost lot prices. But a competitive economy ultimately counteracts these mechanisms and imposes the entire cost of the tax on current owners by reducing property values.

Economic theory holds that an efficient public finance system should result in individual tax burdens roughly equating to the taxpayer's benefit from public expenditures the taxes support, and that anything funded by property taxes should enhance the social and economic environment of property owners.

In the short term, imposing an added tax on property without a corresponding increase in the level of government services disrupts the efficiency of real estate markets. The additional tax drives up ownership costs, thereby reducing effective demand for the taxed property. It results in less development, higher prices to consumers and reduced revenues to developers, in part because of the economic activity that **does not** occur because of the tax.

Fewer potential homebuyers can afford a new house. Fewer retailers can afford to rent space for a shop. Every class of property owners subject to the added tax faces the same prospects. Although markets act to create these conditions, value added through enhanced public services financed by the taxes make it difficult to verify this effect with market data.

Long-Term Impact

In the long run, competitive pressures limit an owner's ability to pass the tax to end users. Suppose an owner negotiates leases requiring tenants to pay property taxes. These leases allow the owner to avoid the costs of the added tax in the intermediate run by passing on the increase to tenants.

However, as leases expire, tenants typically explore available options. When they find comparable space not subject to the tax increase, they move to the lower-cost location. As more and more tenants exercise that option, the property owner is forced to reduce rents to keep the building occupied.

This competitive pressure drives down rent by the amount of the property tax, and the rent reduction returns the tax burden to the property owner. When the owner sells, prospective buyers regard the elevated tax burden reflected in reduced rents as an ownership cost and consider that cost in formulating their offers. Over time, then, the economic system reduces property prices to equal the increase in taxes.

Suppose now that instead of a localized increase like those initiated by the Robin Hood plan, the property owner sustains a tax increase applying to all taxable properties in Texas, again with no increase in public services. In this scenario, no real estate investments escape the increased tax, so there is no pressure to lower rents. Tenants cannot escape the tax by moving. In fact, the tenant seems to shoulder the entire tax burden.

Despite that appearance, markets for investment capital again return the tax burden to the property owner. Investors consider the return an investment will generate before they commit capital. Property owners selling real estate must lower the asking price to compensate for the added tax burden.

The property tax has evolved from a generalized tax on all wealth to one mainly concentrated on real property. Investment alternatives not subject to property tax vie with real estate for capital, and that competition tends to drive down real property prices to compensate for the tax on its value. So once again, the tax burden returns to the property owner through reduced prices for real estate.

This is true for all types of real estate because real estate cannot be moved. Capital can be transferred and labor can migrate to locations that provide superior returns, but real estate is stationary. Because capital and labor are mobile, they can earn the competitive market rate for an economic activity.

However, real estate yields only the income remaining after capital costs and labor have been paid. Property taxes reduce that residual income and thus lower a property's investment value.

Taxpayer Reactions

Although the modern real estate economy is considerably more complex than the simple system outlined here, the discussion demonstrates how real estate investors react to property tax levels. Essentially, they try to avoid a higher tax burden when they purchase a property. Investors shop around among locations, seeking one with equivalent public services but a lower property tax rate.

Corporate managers choosing a location for a facility also consider tax rates. When other factors are equal, they choose the location with the most favorable tax climate. In the end, buyers go where taxes are lowest when all other factors are equal. The proliferation of tax increment finance zones and tax abatements to recruit industry and development reflects this.

The Texas property tax system with its complicated mixture of exemptions and preferential valuation provisions unquestionably affects real property decisions. Buyers weigh the tax implications of a home or other real estate purchase.

School tax freezes on homesteads of those older than 65 provide the elderly an incentive to locate in districts with low property tax rates. Further, it encourages them to purchase low-cost homes to establish a low school tax liability, because that freeze can be transferred to another home.

The property tax affects land use patterns as well. For example, because owners no longer need livestock to qualify for advantageous "open space" taxation, livestock will vanish from much of the land purchased for recreational use. These effects cross state and local boundaries and pit one location against another in setting property tax rates and exemptions.

Texas officials have chosen to rely increasingly on local property taxes to fund public education and, as the need for funds is expected to escalate, the already high property tax burden on Texas property owners will increase. This will tend to reduce real estate values below their expected levels and encourage owners to look for methods to avoid the tax. Many will seek legal advice as they strive to structure ownership to minimize school tax liabilities.

All of this translates into increased ownership costs, which in turn translate into reduced affordability. Continued heavy reliance on the property tax to fund education could adversely impact the supply of affordable housing in the future. Texans would do well to consider this as they search for an optimal school finance system.

Dr. Gilliland (c-gilliland@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

Director, Dr. R. Malcolm Richards; **Associate Director,** Gary Maler; **Chief Economist,** Dr. Mark G. Dotzour; **Senior Editor,** David S. Jones; **Associate Editor,** Nancy McQuistion; **Assistant Editor,** Kammy Baumann; **Assistant Editor,** Ellissa Bravenec; **Art Director,** Robert P. Beals II; **Graphic Designer,** J.P. Beato; **Circulation Manager,** Mark W. Baumann; **Typography,** Real Estate Center; **Lithography,** Wetmore & Company, Houston.

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.