

An Unfettered Property Tax in Illinois

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Abstract

We evaluate property tax systems using the economic criteria of equity, efficiency and simplicity. We apply these criteria in an evaluation of both a stylized constrained property tax system in which tax rates, tax revenues or assessments are limited and an unfettered property tax system. We frame our exploration within standard models of local government behavior.

The effects of property tax constraints on equity, efficiency, and simplicity depend on the nature of local government behavior. If local government behavior more closely resembles a benevolent dictator, the imposition of revenue and rate limitations reduces efficiency. A market value assessment system will tend to perform best in terms of equity, but it is not likely to be nearly as transparent as a fixed value or acquisition value system. However, transparency is relatively unimportant if the government acts as a benevolent dictator.

Under Leviathan governments, limiting local government access to revenues and tax rates is likely to increase efficiency. In addition, assessment systems that lower the cost of monitoring government are more attractive if government behaves according to the Leviathan model. Fixed and acquisition value assessment systems allow for local government revenues and expenditures to be monitored at lower cost to voters than under market value assessment. On equity grounds, market value assessment is likely to be superior whether government behaves as a budget-maximizing bureaucrat (Leviathan) or as a benevolent dictator.

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An Unfettered Property Tax in Illinois

Introduction

The property tax is the most important independent source of local government revenues in the United States. Local government collection of property taxes funds the provision of local government services such as schools, public safety, fire protection, and transportation. Because of its importance to local government finance, reforms of the property tax system are constantly debated and the debates recycle over the years. For example, proposed reforms have involved both the imposition of property tax limitation measures and their elimination.

Property tax limitations are prevalent in the United States. As of 2006, forty states constrain local government property tax revenues by limiting tax rates, limiting revenues, or limiting both rates and revenues. Illinois is one of twenty-three states that limits both local property tax rates and revenues. In addition, assessment limits are imposed by state governments in over twenty states, including Illinois, further complicating property tax systems.

These complicated property tax systems are difficult for voters, policymakers, and researchers to understand, let alone reform. In order to facilitate meaningful policy discussion, in an earlier companion piece we explained in great detail the property tax institutions in Illinois. Armed with a basic knowledge of the institutional details of the Illinois property tax, we begin the present paper with a policy discussion of property tax constraints in Illinois and across the nation.

Criteria for Evaluating Property Taxes

In order to discuss the potential benefits and costs of the property tax constraints in Illinois we compare a property tax system with constraints to an unfettered system. We make the comparison of an unfettered system to a constrained system using the criteria of equity, efficiency, and simplicity, and we assume that the constrained and unfettered systems collect the same amount of property tax revenues to be used for providing local government services.¹ Comparing the equity, efficiency, and simplicity properties of constrained and unfettered systems identifies and clarifies important issues concerning the direction of and need for property tax reform.

Equity

The equity of a property tax system is measured by the relationship between the ultimate distribution of the tax burden and societal notions of fairness. For example, should two

¹ Total revenues and revenues for public service provision differ because of the administrative costs of the tax system. The systems may collect different amounts of total revenues in order to cover differences in administrative costs. These differences inform as to the simplicity of a tax system.

families of identical well-being pay the same amount of property taxes, and should a family with a higher level of well-being pay more in property taxes? In the context of tax systems, the two most commonly referenced equity standards are horizontal equity and vertical equity. A property tax system in which individuals with identical incomes pay identical property taxes is a horizontally equitable system. When individuals with relatively higher incomes pay relatively more in property taxes as a share of income a property tax system is vertically equitable.²

Efficiency

The behavioral distortions of a tax are considered the economic or efficiency costs of a tax. All else equal, it is desirable that a tax system raise revenue with minimum efficiency costs. The efficiency costs of a tax system refer to the excess burden of the tax or the deadweight loss, defined as the loss in social welfare attributable to the behavioral changes induced by the tax. For example, if property tax system A would yield the same amount of revenue as system B and yet result in a higher level of local economic growth, system A would be more efficient than system B.³

Simplicity

It is also desirable for a tax system to be relatively simple. Comparing the simplicity of two tax systems involves a comparison of the costs imposed on taxpayers and tax administrators by revenue-equivalent tax systems. The main costs of a tax system include the costs of compliance and administration. A simpler and less administratively costly tax system is desirable because it collects the same amount of revenue to be used for local government services at a lower cost. A more transparent property tax system may also make it easier for taxpayers to monitor the performance of local government officials.

Defining the Property Tax

All property tax systems are defined by a definition of the tax base and by local government access to the tax base. Defining tax base involves specifying how each individual taxpayer's property is valued for tax purposes. Once each individual piece of property is appropriately valued, these values are summed to produce the total tax base. The value of a single taxpayer's property is referred to as that taxpayer's *own value*. Aggregating the own value of all taxpayers produces the total tax base, referred to as *total value*.

² The concepts of vertical and horizontal equity apply generally to the concept of *ability to pay*. Under the property tax, ability to pay can be measured by the market value of an owner's property. Alternatively, society may view income as a superior measure of ability to pay.

³ The approach widely used in economics defines efficiency in terms of a social welfare function. A social welfare function weights the well-being of different members of society to produce a measure of overall social welfare. A policy goal is to maximize social welfare while raising a given amount of revenue.

Access to tax base is the ability of a government entity to set taxes at desired levels and therefore to impose tax liability on a property. A single taxpayer's tax liability, referred to as *own taxes*, equals the product of her *own value* and the local tax rate (τ). Aggregating own taxes over all taxpayers located within the government's taxing district produces the total revenue remitted to the government, referred to as *total taxes*. The tax rate is the ratio of total taxes to total value.

The steps to determining own taxes are as follows. The assessor measures the value of each property within a jurisdiction and determines the total assessed value of the jurisdiction. Next, the jurisdiction determines total required (desired) revenues. The statutory property tax rate falls out as the ratio of total required revenues to total assessed valuation. This statutory tax rate is then applied to each parcel in the jurisdiction, resulting in each taxpayer's liability or own taxes. We can portray a property tax system by the following identities:

$$\tau \equiv \frac{\text{total taxes}}{\text{total value}}$$

$$\text{own taxes} \equiv \tau \times (\text{own value})$$

$$\text{own taxes} \equiv (\text{total taxes}) \times \left(\frac{\text{own value}}{\text{total value}} \right)$$

The last identity demonstrates that an individual property owner's tax liability depends on the amount of money being collected (i.e., total taxes), the taxable value of the property owner's property within the taxing district (i.e., own value), and the total taxable value of all taxable properties within the taxing district (i.e., total value). In words, a property owner's tax liability depends on two factors: the total taxes, as set by the jurisdiction, and the property owner's share of total assessed valuation in the jurisdiction. Note that this share can vary either because the value of the owner's property changes or because the values of other properties in the jurisdiction change.

Access to the tax base – can the jurisdiction set taxes in an unconstrained fashion? – and definition of tax base – does the jurisdiction assess property according to current market value? – differentiate the constrained and unfettered property tax systems. An unconstrained, or unfettered, property tax system is defined as a system that places no constraints on local government access to the tax base. That is, there is no legal limit on total taxes in any time period. Constrained systems impose legal limits on local government access to the tax base. Limits on access to the tax base will constrain the amount of tax revenues (i.e., total taxes) that can be legally collected in a period. Total taxes (i.e., revenues) may be limited directly through revenue constraints, indirectly through tax rate constraints, or through limitations on both revenues and rates.

The analysis in this report considers four mutually exclusive definitions of tax base (i.e., own value). The accuracy of local assessment is assumed to be the same across all four definitions of tax base. This does not assume, however, that assessments are produced at

no cost. The four definitions of tax base are current (or market) value assessment, fixed assessment, acquisition value, and classification.

Market value assessment assumes that all own values are annually updated to reflect the current market values of all property. Fixed assessment assumes that all properties are assigned a market value for a common year and that these values do not change over time.⁴ For example, a fixed assessment system could define each property's own value in all periods as each property's market value in 1950.⁵ Fixed assessments are an extreme version of policies that limit growth in individual assessments over time. Under a fixed assessment definition of tax base, the growth in individual assessments is limited to zero percent over time.

An acquisition value system, similar to the current system in California, defines each property's own value as the purchase value of the property. That is, the own value of a property may only change when it is sold. A classification system defines the own value of each property as a percentage of its current market value, with these percentages (i.e., classification rates) differing across property classes (e.g., commercial, residential, industrial, apartment, non-profit, etc.).

The different assessment systems only define tax base and do not directly limit local government access to tax base. They can, however, have important effects on the efficiency, equity, and simplicity of a property tax system.

Efficiency Concerns

The efficiency implications of property tax constraints depend importantly on the nature of local government behavior. This analysis considers the efficiency implications of property tax constraints under two extreme conceptions of local government behavior. While these extremes are unrealistic, and the truth is certainly somewhere in between, analysis of the two extreme cases demonstrates the most important efficiency issues.

Benevolent Government

Consider the first extreme of local government behavior in which local governments conduct all policies by a majority vote and the preferences of the local majority completely guide local policy decisions. This is often called the median voter model because, under certain assumptions, a majority voting system will result in policies that follow the preferences of the voter with median preferences. In the context of the median voter model, the argument for limiting access to tax base and hence limiting revenues is weak. The government can be viewed as a benevolent or altruistic dictator, choosing policies with the singular goal of maximizing the well-being of the electorate. Indeed, constraining a benevolent government might be considered misguided at best and

⁴ Actually, what is important is that the relative values do not change over time.

⁵ A fixed assessment policy would have to describe methods for assessing the own value of new construction as well as renovations or improvements to existing properties.

malevolent at worst. Limiting a benevolent government's access to tax base will not increase efficiency and may actually reduce efficiency. For example, if local voters are willing to pay higher property taxes to fund a brand new computer lab in the local high school, it is difficult to argue that they should be denied. If denied, local voters may circumvent the limitation by raising the required revenue in a less efficient manner or by concealing revenues from oversight agencies. The concealing of revenues and search for alternative revenue sources all have costs and result in the same output being provided at a higher cost. This is the very definition of inefficiency.⁶

Leviathan Government

At the other extreme of government behavior from benevolent government is the budget-maximizing, self-aggrandizing bureaucrat. Under this Leviathan model of local government, local officials act to maximize their own well-being. The well-being of government officials may be a function of factors such as the size of the budget, the size of the staff, and the quality of office furniture and computers. The only constraint on the desire of bureaucrats to enrich themselves is the need to get re-elected or re-appointed so that they can keep enriching themselves. In the Leviathan model, voters are simply pawns of the elected or appointed officials and do not have the power to make tax and expenditure policies correspond well with their preferences. Much of the tax revenue collected under a Leviathan local government is wasteful and thus inefficient. Everyone, with the exception of the bureaucrats, could be made better off by reducing tax revenues, eliminating wasteful spending, and maintaining the same level of real government services.

Under a benevolent government, local voters do not have to monitor local government performance. With Leviathan local government, however, it is only this monitoring of government performance (and the need for reelection on the part of self-aggrandizing bureaucrats) that mitigates the government's ability to appropriate taxpayer resources.

Perhaps the simplest method for a taxpayer to monitor local government is to compare her tax bill to the quality of the services that her government provides. For example, if her tax bill increases but she sees no corresponding increase in the quality or quantity of government services she might suspect wasteful spending. Changes in her tax bill, however, are not necessarily a good signal of an increase in government tax revenues. Consider again the own taxes identity from above; an individual's tax bill (i.e., own taxes) may change over time because of changes in total taxes or changes in her tax share (i.e., the ratio of own value to total value). Under market value assessment, her tax share may change because own value changes or total value of the jurisdiction changes. It may be costly for her to determine what portion of an increase in her tax bill is caused by an increase in total taxes (and possibly wasteful expenditures) and what portion is caused only by changes in her tax share. Because of the costs of correctly interpreting changes

⁶ Limitations often include override provisions that allow for a vote to exceed limitations. This can help reduce inefficiency but even the calling of a vote has administrative costs that are unnecessary in the presence of an altruistic local government.

in tax bills, market value assessment makes it costly to monitor local government behavior. An increase in the costs of monitoring can allow Leviathan governments to be even more inefficient than otherwise. These same higher monitoring costs will exist under a classification system, since the underlying appraisals are based on market value.

A fixed value assessment system might lower monitoring costs by enabling an individual taxpayer to understand exactly how to interpret her tax bill. Without new construction or improvements, her tax bill will increase only as the result of increases in total taxes because her tax share remains constant over time.⁷ Under a Leviathan government the reduced costs of monitoring can be an essential part of reducing the ability of the self-aggrandizing bureaucrats to undertake large amounts of wasteful expenditures. Assuming relatively small amounts of new construction, monitoring costs may also be relatively low in an acquisition value system because an individual property value will only change when a property is sold. This will cause tax shares to change more often under an acquisition value system than under a fixed value system, but changes in tax shares may be smaller and occur less frequently than they would under market value assessment.⁸

Simplicity Concerns

All else equal, it is desirable for a tax system to be simple. Simplicity involves the ease with which the tax system is understood and complied with and the costs of administering the system. The simplicity of a property tax system can be judged separately from the question of the nature of local government behavior.

Complying with and enforcing state limitations on rates and revenues may be administratively costly for both local governments and the state. Most revenue limits constrain the amount that property tax revenues can increase from one year to the next. In order to enforce these limits state governments must maintain databases of past revenues. Furthermore, most legal limitations on rates and revenues are subject to a variety of exceptions to the rule. For example, it may be possible to increase revenues dedicated to capital expenditures by more than 5% while other revenues may only increase by 5% each year. Local governments must put effort into understanding the definition of capital revenues and the state must make sure that local governments are actually following the definition and not evading the limitation. By simply avoiding these compliance and evasion costs an unconstrained system is much simpler than a constrained system.

⁷ New construction will cause tax shares to change. The relative magnitude of these changes may be much smaller than the potential for tax share changes under market value assessment.

⁸ Besides the frequency of tax share changes there are also the issues of the magnitude and variance of tax share changes. Under fixed value assessment, changes may be non-existent or very small. In the other systems, the magnitude of changes in tax shares will depend on the real estate market. For example, when all properties appreciate at the same rate, tax shares would be invariant under a market value assessment system.

Assessment systems also have different implications for relative simplicity. As explained above, under market value assessment own value is continually updated in order to reflect the market values of real estate. In practice, continual updating usually implies annual updates to own values. Determining accurate assessments of market value for every property can be very expensive. Annually updating these values creates large administrative costs for both taxpayers and tax administrators. Taxpayers must monitor the accuracy of assessments and possibly appeal inaccurate valuations. Tax administrators must not only produce accurate assessments but they must also keep complete and updated records and handle appeals. Annual updates to property values should appear transparent and predictable, not mysterious and capricious. In addition, the state government may also incur costs if it chooses to monitor the quality of local assessments. Hundreds, perhaps thousands, of full-time administrators must be hired not only to assess properties annually but also to monitor the quality of the assessment process.

Fixed and acquisition value assessment systems have much lower administrative expenses than a market value assessment system. The fixed and acquisition value systems need to produce accurate assessments only once and there is no need for constant updating of all records. Fewer administrators will need to be hired at both the state and local level, and there will be much less need for individuals to appeal assessments or determine assessment accuracy. The costs of compliance are low and the assessment system is very transparent.

Equity Concerns

Because equity is defined in relation to the distribution of the tax burden, and the assessment system determines that distribution, the discussion of equity is a discussion of the four different assessment systems outlined above.

If income is superior to property value as a measure of ability-to-pay, all assessment systems will fail to some extent to distribute the tax burden according to societal notions of fairness. The exact nature of the failure to achieve equity will depend on the exact nature of the relationship between property values and incomes.

Permanent income can often be a better measure of ability to pay than current income. For example, a retired person owning a \$2 million mansion may have a low current income, but society will likely view her as having a high ability to pay. When permanent income is strongly associated with the market value of one's property a market value assessment system distributes taxes on the basis of permanent income. Society may deem this fairer than a system that distributes taxes based on current income.

Market value assessment can change the distribution of the tax burden as market values change. Fixed and acquisition value systems, however, do not allow for any significant changes in the distribution of the tax burden. Under an acquisition value system, a relatively low income person who purchased her home last year could easily pay more in

taxes than a wealthy individual who purchased his home 20 years ago. A fixed assessment system can produce the same kind of inequality because, regardless of income, own value is fixed.

Although fixed value assessment can potentially lead to current tax payments that are misaligned with ideas of fairness, capitalization of property taxes into market values can ameliorate much of this unfairness. Property taxes are capitalized into the market value of a property when estimates of the future property tax obligations on the property affect buyers' bids for the property. The idea that future tax obligations on a property affect its sales price is not implausible and is confirmed by much evidence. Consider two parcels of real estate that are otherwise identical except that the owner of one property pays twice as much in property taxes as the other owner. The sales price for the high-tax property should be lower than the sales price of the low-tax property. In a competitive real estate market, the price of the high-tax property should be lower by exactly the discounted value of future tax differences. Thus, even though one owner pays twice as much in property taxes, she paid less for her property than the other owner. If her purchase price was lower by the exact amount of future taxes, she is not bearing the economic burden of current tax payments. In this way, capitalization reflects the true economic burden of current property taxes and demonstrates that current tax payments do not necessarily reflect the true economic burden of the tax.

Capitalization of property taxes is a result of a properly functioning real estate market and as such is not confined only to one type of assessment system. Under market value assessment estimated future tax obligations should also be capitalized into current market values. When future tax payments are perfectly predictable only current owners bear the burden of future property taxes in the form of lower sales prices. When taxes are fully capitalized into market value, current differences in tax payments are already incorporated into the market value of properties. While current owners can receive one-time windfalls or losses, new buyers of property will pay more, all else equal, for properties that pay lower taxes.

Capitalization of property taxes into current market values thus eliminates or ameliorates much of the unfairness cited above. For example, consider a relatively low income person who is paying more in property taxes than a relatively wealthy individual. This disparity in current property tax payments is often considered unfair. It seems less unfair, however, when it is discovered that the relatively low income person paid substantially less for their home (perhaps enough to offset the higher property taxes) and the high income person substantially more. Regardless of capitalization, however, the existence of disparities in current tax payments can easily create the perception of unfairness.⁹

⁹ The main determinant of the extent of capitalization is the real estate market's ability to make accurate predictions of future tax payments. It may be easier to accurately forecast future tax payments under a fixed value or acquisition value assessment system than under a market value assessment.

When income (permanent or current) is generally positively related to property values, of all the systems considered here, market value assessment distributes the tax burden most equitably. While the substantial cost advantages and relative transparency of fixed value assessments may make it an attractive option, the potential conflicts with societal notions of fairness make fixed assessed values much less attractive.

When market values are assumed to measure ability to pay perfectly it is easier to distinguish among the assessment systems. A market value assessment system will do best at maintaining horizontal and vertical equity in actual tax payments as market values change. A classification system will sacrifice exact horizontal and vertical equity in order to appeal to other notions of fairness (e.g., commercial properties should pay more in taxes than residential properties, all else equal). Fixed and acquisition value assessment systems will reduce the potential for volatility in individual tax shares and thus individual tax payments, but these systems may not perform well in terms of equity. Capitalization of property taxes into the market value of real estate will reduce inequality in the economic burden of current property taxes. Differences in property taxes are more likely to be fully capitalized into market values when future tax liabilities can be accurately predicted.

Evidence on Local Government Behavior

The choice of an assessment system (i.e., the definition of tax base) involves concepts of equality and simplicity. In the presence of Leviathan government, an assessment system can affect the costs of monitoring government decisions. We have argued that monitoring is less costly under a fixed assessment system than under a system based on current (market) value assessments. The effects of restricting access to tax base (i.e., revenue and rate limits) on efficiency depend on the existence of Leviathan governments; if governments act benevolently, restrictions on access to tax base are likely to harm efficiency, whereas limits on taxes might restrain Leviathan governments from spending excessively. Thus, the main determinant of much of this analysis is the likelihood that government behavior more closely resembles the Leviathan than the benevolent dictator.

What is the evidence on the presence of Leviathan government? Many studies have analyzed the effect of property tax limitations on local government revenues and tax rates. If governments act as self-aggrandizing bureaucrats, we would expect to see an effect of limits because we would expect the limits to be binding. The evidence suggests that limitations on revenues and rates are binding, in that they appear to reduce the growth rate of property tax revenues.¹⁰ The effectiveness of limits is consistent with the existence of Leviathan governments.

¹⁰ Preston and Ichniowski (1991) examined the effects of limits on municipal revenues, Poterba and Rueben (1995) examined the effects of limits on the public-sector wage premium, Dye and McGuire (1997) examined the effects of limits on property taxes in Illinois, and Cutler, Elmendorf and Zeckhauser (1997) examined the effects of Proposition 2 1/2 on municipal property taxes in Massachusetts. All found that limitations are effective.

Voter support for limitations is also consistent with the existence of Leviathan government. Many limitations were passed by state-wide initiatives, Proposition 13 being the most prominent example, and others are instituted through state-wide referenda. In a study of the decision of Illinois municipalities to adopt home-rule status and therefore to throw off state-imposed rate limits, Temple (1996) found that less than ten percent of the cities in her sample chose to do so. We would not expect to see voter support for limitations if local governments were benevolent.

In a study of school district spending in California before and after the passage of Proposition 13, Downes (1996) found that school officials valued spending on support staff above and beyond the effect on student outcomes of spending more on support staff. He also found that school officials placed a higher value on student outcomes after the passage of Proposition 13 than they did before its passage. Both of these findings are consistent with Leviathan government.

The effects of property tax constraints on equity, efficiency, and simplicity depend on the nature of local government behavior. If local government behavior more closely resembles benevolence the imposition of revenue and rate limitations reduces efficiency. A market value assessment system will tend to do best in terms of equity, but it is not likely to be nearly as transparent as a fixed value or acquisition value system. However, transparency is relatively unimportant if the government acts as a benevolent dictator.

Under Leviathan governments, limiting local government access to revenues and tax rates is likely to increase efficiency. In addition, assessments systems that lower the cost of monitoring government are more attractive if government behaves according to the Leviathan model. Fixed and acquisition value systems allow for local government revenues and expenditures to be monitored at lower cost to voters than under market value assessment. On equity grounds, market value assessment is likely to be superior whether government behaves as a budget-maximizing bureaucrat or as a benevolent dictator.

Local government is certainly not inherently Leviathan or benevolent. It is likely that a transparent property tax system would reduce the ability of Leviathan government to persist. Voters should be able to understand, at little cost to themselves, the reasons for an increase in their assessments and in their tax payments. Taxpayer confusion may not only allow Leviathan governments to persist but it may also cause reasonably benevolent governments to be inefficiently constrained.

Evaluating Current Property Tax Institutions in Illinois

As noted above, Illinois is one of 23 states that limit both the tax rates and tax revenues that can be selected by many of its local taxing jurisdictions. Limits on assessment increases and a classification system are currently used in Cook County. In addition, Illinois counties are not required to annually update the assessed value of individual properties. Illinois, Cook County in particular, strays far from the unfettered property tax

system described above. The departures from the unfettered system affect the equity, efficiency, and simplicity of the Illinois property tax.

The institutional departure from an unfettered system that applies to the greatest number of taxing districts in Illinois is tax rate limitations. These limits set a maximum tax rate that a taxing district can employ. As noted above, tax rate limitations restrict government access to the tax base but do not alter the definition of tax base. Taxing districts subject to these limitations include all school districts, all counties except Cook, and non-home rule municipalities. Most municipalities in Illinois are not home rule, with only 197 of 1,290 municipalities classified as home rule in 2000. Although it is unclear exactly how often the rate limits actually bind (i.e. force a taxing district to have a lower tax rate than it would otherwise prefer) these limits must enter into the policy choices of limited districts.

The tax rate limits in Illinois are incredibly complex and require their own manual. The limits on tax rates are different across types of taxing districts and also differ across funds within the same taxing districts. The implementation of these limits clearly reduces the simplicity of the property tax system and drives up administrative costs. Administrative costs rise because effort must be put into understanding, explaining, and complying with the limits. Even though the system allows taxing districts at least to override rate limitations temporarily, the overrides are themselves administratively expensive endeavors with uncertain outcomes.

If, however, school districts in Illinois are prone to wasteful expenditures, the rate limits could produce a reduction in these wasteful expenditures. Of course, the districts might just as easily reduce arguably useful expenditures in order to maintain the wasteful expenditures that budget-maximizing bureaucrats desire. Again, the evaluation of efficiency requires judgments about the nature of local government behavior. The most efficient local governments, however, are clearly worse off as they must bear the burden of the administrative costs of tax rate limits without any corresponding efficiency benefits.

Rate limits themselves will not affect equity within a district as they do not change tax shares and can only serve to reduce total revenues. The limits themselves, however, apply inequitably across districts. Although all districts are constrained by the same rates, districts with low levels of property wealth are more constrained by the rate limits. The rate limits do not directly limit property tax revenues since districts with large and growing tax bases will be able to raise revenues at lower rates than other taxing districts. Since taxing districts ultimately desire revenues as opposed to tax rates, the rate limitation will only effectively constrain property tax revenues in districts with relatively small property tax bases.

Illinois's revenue limitations law, the Property Tax Extension Limitation Law, does not apply as widely as the tax rate limitations but still reduces the simplicity of the tax system. As of 2006, non-home rule districts in 39 counties were subject to the PTELL. As with rate limits, the limitations on revenue increases restrict access to the tax base but

do not alter the definition of tax base. PTELL also requires its own manual but is remarkably less complicated than the myriad of tax rate limitations. The law only requires that annual percentage increases in total taxes do not exceed the lower of either 5% or the rate of inflation. Still, the administrative costs are arguably large since the state government must provide oversight and taxing districts face the costs of compliance.

As with the tax rate limits, the revenue limits will not affect equity within a taxing district since the revenue limit does not change individual tax shares. The justification for reducing simplicity is then potential gains in efficiency resulting from restraining Leviathan governments. Again, the most efficient governments are harmed by the limitation on increases in total taxes. Overrides are available, but even if higher than allowed revenues are desired by a majority of residents an override may not be undertaken because of the costs and uncertain outcome of a potential referendum. Only when the benefit of increased revenues exceeds the administrative costs and uncertainty surrounding placing an override on an election ballot will an override be called. The administrative costs and uncertainty can lead to less than efficient amounts of revenue being raised through the property tax.

The empirical evidence on the effects of PTELL in Illinois suggests property tax revenues in school districts subject to the limitation often grow more slowly than property tax revenues in unlimited school districts. It has also been shown that school districts subject to PTELL in Illinois tend to exhibit slower growth in administrative expenditures than districts not under the limit. Furthermore, limited districts exhibit no different trend in the growth of instructional expenditures. If administrative expenditures are viewed as possibly excessive or inefficient, then the lower growth in administrative spending in limited districts suggests an increase in efficiency. Of course, a possible increase in efficiency in some districts does not imply that every district should have a revenue limitation. The general conclusion of the economics literature is that revenue limitations do appear to result in slower growth in property tax revenues and expenditures in both the short run and long run. Thus, although PTELL does result in greater tax complexity it does appear to increase the ability of some local residents to prevent large increases in property tax revenues.

The other departures from an unconstrained or unfettered property tax system are the lack of a requirement for annual updates to assessed value across the state, and assessment limits and classification in Cook County. These features of the Illinois property tax affect the definition of the tax base rather than access to the tax base. In all counties except for Cook, the own values of all property are to be updated at least every four years. In practice, assessors appear to update individual own values more frequently. In Cook County, all properties are divided into one of three assessment districts and the value of any single property is usually only updated once every three years. As noted above, non-annual assessments reduce the administrative costs of assessments and make the property tax system less complicated. Requirements to update all the property values in Cook County would require large annual expenditures on property assessment.

A change to annual assessment could increase the equity of tax payments at one point in time if home value is an appropriate measure of permanent income or ability to pay. Annual updates may also act to “smooth out” large increases in own values that might occur if values are only updated every three to four years. Annual updates, however, may be more affected by short-term trends in real estate markets that do not accurately reflect the long-term value of property or taxpayer ability to pay. Furthermore, without a significant increase in the funding of assessment practice, switching to required annual updates would likely result in less accurate assessments. An increase in inaccurate assessments would increase the amount of valuation appeals, creating even higher administrative costs.

The most important aspect of assessments is that the process be transparent and easy for taxpayers to understand. Given the limited resources available for property assessment a proper balance between accuracy and equity is very important. The costs of annual assessments must be weighed against any perceived gains in equity.

The last two policies affecting the definition of the tax base are classification and the Cook county assessment limit. Classification and assessment limits in Cook County create different distributions of the statutory tax payments than would occur under a system that apportioned tax payments based solely on estimated market values. Both policies, assessment limits less transparently, create larger tax payments for owners of non-residential property than would occur under a market valuation system. Also, both policies shift the statutory burden of taxes across taxpayers rather than reducing property taxes as a whole.

Since classification involves only the multiplication of estimated market value by a class rate, it is difficult to argue that it makes the property tax system more complex in any substantive way. Classification may, however, have effects on both the equity and efficiency of the tax system.

If the market value of property is the best measure of ability to pay then the classification system results in a departure from distributing the statutory tax burden on the basis of ability to pay. Also, by raising the statutory tax burden on owners of business capital, classification may cause business to alter their location decisions. The alteration of business location decision due to taxation is generally seen as an inefficient reallocation of resources.¹¹

Since classification is likely to produce inefficiency a strong argument involving equity must be made as justification for classification. An honest debate of the equity effects of classification must reflect on the fact that people, not businesses, pay taxes. A building cannot write a check and remit property taxes, some person’s or persons’ real incomes must be reduced as a result of taxation. Thus, although it may be tempting to think of

¹¹ See Dye, McGuire, and Merriman (2001) for a study of how classification affected business activity in the Chicago metropolitan area.

increasing property taxes on commercial property as a reduction in taxes paid by people, this is clearly not true.

It is possible that increases in property taxes on commercial property may result in an increased share of property taxes being paid by non-residents, if the owners of the property are non-residents. It may be desirable for residents to export their taxes to non-residents in this way. Property taxes on business, however, will not always be exported. Business owners may increase prices or lower wages as a result of the an increase in property taxes. For these and other reasons, it is often the case that the people bearing the actual economic incidence of the tax burden are not the same people that simply remit the check to the government. Given the ability of business owners to pass on their tax burden to employees and consumers it is difficult to argue that classification creates a more equitable property tax system.

The assessment limit that currently applies to residential properties in Cook County is officially known as the Neighborhood Preservation Homeowner Exemption. The assessment limit does not make the property tax system any simpler. By administering the policy as an exemption as opposed to an assessment cap, the policy creates confusion and is difficult to understand. Implementing the assessment limit increases the administrative costs of the tax system. The policy is set to expire in Chicago for taxes payable in 2007 but there is still time for the legislature to renew the bill.

The assessment limit will effectively restrict increases in own value and as a result increases in tax share. Yet an increase in one taxpayer's tax share must result in the increase in at least one other taxpayer's tax share. As with classification, the ineligibility of non-residential properties shifts the statutory property tax burden away from residential homeowners. As before, the ultimate economic incidence of the tax may differ from the statutory incidence so the equity implications cannot be gauged from the tax bills alone. Furthermore, the assessment limit will shift the statutory burden away from residential properties experiencing large appreciations in value and towards relatively low appreciating residential properties. These shifts may be desirable if taxpayers wish to insure against large and unexpected increases in property taxes. Of course, assessment limits are not the only way to provide insurance against unexpected increases in property tax liability. Other solutions include tax deferrals and income tax credits or refunds directed towards those with large property tax increases.

All of the methods of insurance provision, however, must be paid by some taxpayer be it through higher property taxes or higher income taxes. If the relatively large increases in own values represent permanent wealth increases, those experiencing large increases in tax shares and tax payments may have the ability to pay for those increases. It is the case, however, that not all increases in assessed value reflect permanent increases in taxpayer wealth, especially in volatile real estate markets.

Current Reform Proposals

At the moment there is little discussion of major institutional reforms of the Illinois property tax. There is, however, much discussion of tax reform and a goal of much of this tax reform is the reduction of property taxes. The two most prominent tax reform proposals are House Bill 750 and Governor's Blagojevich's proposal for a new gross receipts tax. Both of these reforms propose to increase other taxes in order to provide at least some reduction in local property taxes. House Bill 750 specifically focuses on using the new tax revenues to increase revenues in local school districts across the state.

House Bill 750, spearheaded by the Center for Tax and Budget Accountability, focuses on shifting the emphasis of school funding from local property taxes to income taxes. Providing motivation for the bill is the relatively large degree of local revenue disparities among school districts in Illinois. The bill would increase the state's share of local school district revenues through property tax relief grants directed to school districts with relatively high property tax rates.

The revenues necessary to fund the increase in the state financing of local school districts would come by increasing the flat income tax rate from 3% to 5% and an increase in the corporate tax rate from 4.8% to 8%. The bill would broaden sales taxes to include consumer and recreation services.

The gross receipts tax plan originally involved phasing out the corporate income tax in favor of a flat .5% rate on manufacturers, wholesalers, retailers and a 1.8% rate on almost all other businesses raising about \$6 billion in new revenue. Blagojevich subsequently increased these rates to 0.85% for gross receipts from sales, leases, or rentals of tangible personal property, and 1.95% for all other gross receipts. This would give Illinois the highest gross receipts tax in the country. Blagojevich's plan focuses much less on property tax relief and education finance than does House Bill 750.

Neither of these reforms alters the structural foundations of the Illinois property tax system. If property tax rebates are targeted towards taxpayers with low abilities to pay, society could view the property tax system as more equitable. Any reduction in property taxes, however, is financed with increases in other taxes. These taxes create their own issues with equity, efficiency, and simplicity.

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