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Alternatives to Cook County's 7% Cap on Assessment Increases

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Introduction

Following large run-ups in residential property values, a recent Illinois law allowed Cook County to cap increases in homeowners' property tax assessments. The cap expires soon and is up for renewal. One consequence of an assessment cap is a shift in tax burdens from some taxpayers to others. We examine the cap and a number of alternative policies that might achieve the benefits sought by its proponents with fewer negative side effects.

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Background: Why was the cap adopted?

Property taxation in Illinois is complicated and contentious. Illinois relies more heavily than other states on property taxes relative to income or sales taxes. Cook County has several unusual complications in its property taxes.

Taxes unleash two kinds of fights. First, tax burdens are often resisted or resented. Taxes may be the price we pay for good government (schools, police, roads, parks, etc.), but no one likes paying them. Second, changes in tax law produce winners and losers as they shift the burden from one group to another.

In Illinois there are three main taxes, on income, sales and property. The amount we pay in each is the product of the tax rate—the same for all taxpayers in a jurisdiction—and tax base—which varies from person to person. The sales tax base is largely under the control of the taxpayer since it depends on household purchases. The income tax base tracks taxpayer earnings, so when income increases, the tax base and payments increase too.

The property tax *base* depends upon the value of the taxpayer's real estate. In Cook County an elected Assessor is responsible for determining the value of most residential property. Every third year, three years of property value growth are assessed. When real estate values increase rapidly, the result is occasional large jumps, rather than frequent smaller rises. If the tax rate stayed constant, increases in assessments would lead to increased tax liabilities. However, most local governments in Illinois reduce their tax *rates* when the assessed value of the real estate in their district rises. For example, the Cook County tax rate has fallen in each of the last 10 years, declining 40.3 percent since 1995.

The *overall* tax burden is set by the property tax levies of local governments, and the Assessor's Office *distributes* the burden by assessing each parcel. Partly because of state limitations on increases in local levies, most local governments reduce their

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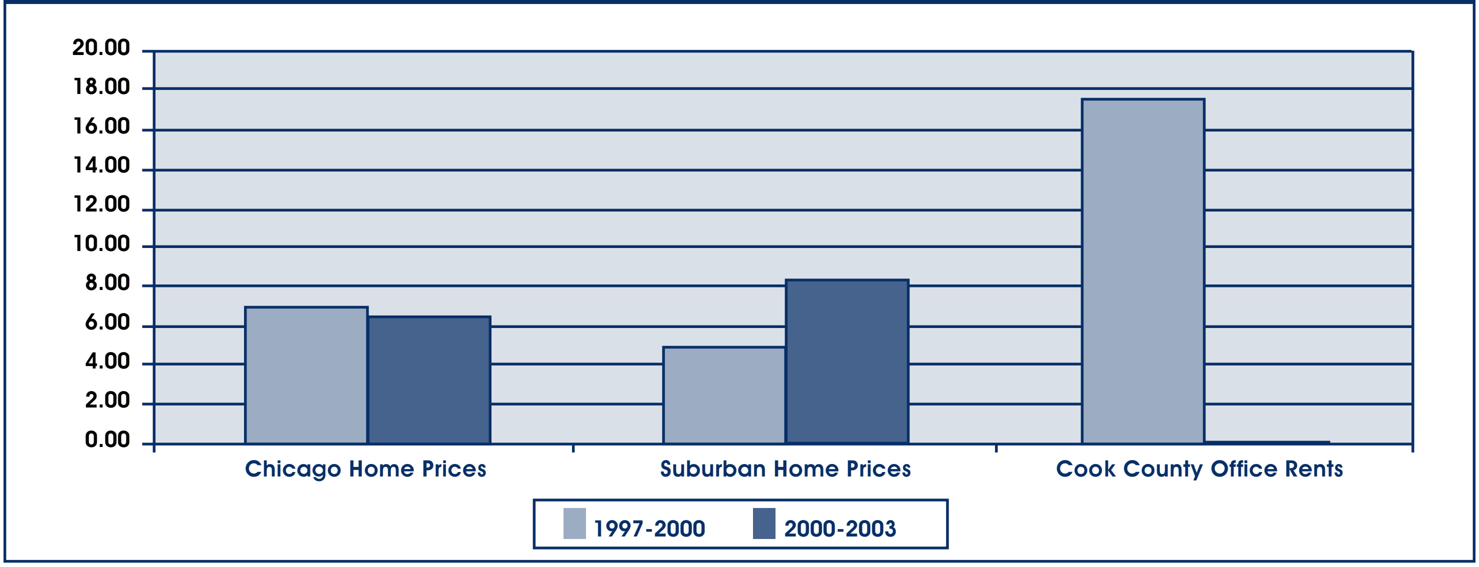
Average Annual Growth Rates for Single-Family Home Prices and Office Rents



Source: Illinois Department of Revenue and BOMA Chicago.

property tax rates such that property tax revenue rises at about the inflation rate. So, *on average*, increases in assessment do not mean increased tax payments. However, people whose assessments rise faster than average see increased property tax liabilities despite the decrease in the tax rate. In neighborhoods that have become especially hot of late, property values have increased very rapidly, and property owners in these neighborhoods were unhappy about the prospect of greatly increased tax payments.

Moreover, in recent years residential property values appreciated faster than commercial and industrial property values, reversing an earlier pattern. The following chart shows the average growth rate in the sales prices in single-family homes in Chicago and the rest of Cook County. While Chicago had steady growth in sales prices over 1997-2003, prices increased rapidly in the suburbs between 2000 and 2003. These averages mask the fact that some neighborhoods in both city and suburbs had far higher appreciation rates. The growth in office rents came to an abrupt stop after a long period of extremely rapid growth. The value of commercial properties is directly related to rents: when office rents stop increasing, sales price appreciation rates fall.

Changing fortunes of residential and commercial property owners have important implications for tax burdens due to "classification," another complicating feature of Cook County property tax law. Classification leads to lower assessment of residential compared to commercial and industrial property, and lower assessments lead to lower taxes. The higher appreciation rates for residential property threatened to reverse the implicit political equilibrium of classification by reducing the higher specified burden for commercial and industrial property.

Such large potential tax increases and burden shifts created political pressure. That pressure was exacerbated by confusion of tax assessments with tax burdens—many taxpayers, even some of our Ph.D. economist colleagues, assume that their tax bill will go up by the same percentage as their reassessment notice and are not aware of the partly (on average, fully) offsetting decrease in tax rates.

What form did the tax cap take?

In response to these rapidly rising assessments, Cook County, with authorization from the state legislature, approved an expanded homeowner exemption in 2004. This law temporarily reduced the assessment of homeowners whose property had appreciated rapidly

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over the prior three years. More specifically: eligible homeowners who experienced increases in assessed value of less than 7 percent got the *general* homestead exemption of $5,000 ($4,500 in 2003); homeowners who experienced property appreciation greater than 7 percent received an *expanded* homestead exemption that effectively capped assessment increases at 7 percent; the maximum value of the expanded homestead exemption is $20,000.

The reduced assessment of recipient homeowners meant lower tax liabilities for most of them. However, since the total revenue collected by local governments did not change, the lower tax liability of some homeowners meant higher tax liabilities for other taxpayers. Tax rates are higher than they otherwise would be—more precisely, tax rates go down less than they otherwise would. Offsetting changes in tax burdens like this are called a "tax shift." The taxpayers on the losing end of the shift from the 7 percent homeowners' assessment cap were owners of commercial, industrial, and rented residential properties. Also worse off were homeowners with less than 7 percent appreciation. Moreover, even households covered by the cap faced tax rates higher than would have been in place without a cap, as the benefit from the expanded homestead exemption is partially offset by higher rates on the remaining taxable property value. Hence, even some homeowners covered by the cap are net losers.

The assessment cap law is due to sunset over the next three years, starting with the Chicago reassessment triad in tax year 2006. The legislature is considering whether to extend it, revise it, or let it end. The Cook County Assessor, the Mayor of Chicago, and many neighborhood groups favor extension; commercial property owners and other business groups are generally opposed.

What happened? How much was saved and shifted?

We conducted a study for the Illinois Department of Revenue to document the extent of the tax shift.[1] We identified which taxpayers gained (paid lower property tax bills than they would have) and which lost as a consequence of the assessment cap. Taxpayers not eligible for the exemption paid about 4 to 6 percent more in taxes, while the eligible received tax cuts ranging from near zero to over 50 percent.

Was that fair? Property owners that did *not* benefit from the assessment freeze—business property owners and homeowners with less than 7 percent appreciation—can argue that they paid higher taxes to protect homeowners who had already benefited from rapid appreciation in their real estate wealth. On the other hand, homeowners enjoying rapid appreciation of property value can argue that large increases in taxes are unfair given that their gains are unrealized when they do not sell the properties. With no more cash on hand, they would have been burdened by increased property taxes with no cap. On average, these households paid about 6 to 14 percent less than they would have without the law, although there was considerable variation around these averages.[2]

There is a ceiling on the benefit, and the maximum tax reduction that any Chicago homeowner got as a result of the law was just below $1,000 in the first year. In subsequent years, with the same ceiling in effect, many homeowners saved less. Without the law, some homeowners would have had to pay almost $3,000 more in tax over the three year period. To be eligible for the maximum benefit of the law we estimate that a homeowner would have had to experience well over $65,000 of real estate appreciation between 2000 and 2003. (This estimate is conservative. To hit the $20,000 ceiling in all three years for a $3,000 reduction over three years, the appreciation would have to have been far higher than $65,000.)

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[1] Richard F. Dye, Daniel P. McMillen, and David F. Merriman. "The Economic Effects of the 7% Assessment Cap in Cook County," report to the Illinois Department of Revenue, Institute of Government and Public Affairs of the University of Illinois, March 2006 (http://www.igpa.uillinois.edu/). Also see: The Civic Federation, *The Effects of the "7% Cap" on Property Taxes Paid in The City of Chicago, Tax Year 2003*, Chicago, Illinois, 2005 (http://www.civicfed.org/pubs_research.php); and Cook County Assessor's Office, *The Impact of the 7% Expanded Homeowner Exemption: City of Chicago Tax Years 2003 & 2004, North District Tax Year 2004, South District Projected Tax Year 2005*, Chicago, Illinois, 2005 (http://www.cookcountyassessor.com/forms/7PerCentImpactReport.pdf).

[2] See Richard F. Dye, Daniel P. McMillen, and David F. Merriman, "Illinois' Response to Rising Residential Property Values: An Assessment Growth Cap in Cook County," *National Tax Journal* (September 2006).

It is important to put the magnitudes of these tax liabilities in perspective. No one likes paying higher taxes, but for many homeowners an increased property tax burden of $1,000 per year (about $80 per month) should not be onerous, when balanced against a $65,000 increase in the real estate wealth. Many of these homeowners could even have deducted increased property tax payments on their federal income taxes, so the net cost could be as little as $650 per year (for someone in the 35 percent federal income tax bracket). High income taxpayers who have substantial savings or pension contributions might choose to finance additional tax payments by reducing their savings. Then, the $65,000 (or more) increase in their real estate holdings could compensate for their decreased savings for at least 65 years.

"All policy alternatives involve trade-offs and burden shifts."

What are the alternatives?

Big year-to-year changes in tax burdens present problems, but the so-called "7 percent solution" assessment cap is just one possible policy response. All policy alternatives involve trade-offs and burden shifts. One of the big trade-offs with the assessment cap is conflict with the principle of "uniformity," that is, taxpayers with the same property value should pay the same tax. Under the 7 percent cap, the owner of a $400,000 house worth only $300,000 in the prior assessment year pays less tax than the owner of another $400,000 house that saw no appreciation. Thus, tax payments depend not only on home value, but also on how prices have increased over time.

Consider some alternative policies.

1. Targeted deferral or "tax loans."

We argue above that increased tax burdens from increased assessments are not often an extraordinary burden. For a small minority of taxpayers, however, the increased tax payments would represent a painful, perhaps insurmountable, squeeze. No one knows how many households are low-income and lacking in cash despite rising property wealth, because no studies have been done on the question.

There are practical problems, but it is possible to help such households without shifting the burden to other, less fortunate property owners, who saw little or no value appreciation. The most obvious strategy would be to give taxpayers burdened with large increases the option to borrow money to pay these bills. The increased value of their real estate would be collateral on the loans. A public sector alternative would be to defer increased taxes until the property is sold.

The tax loan solution makes many people uncomfortable because of the potential to put family homes at risk. Also, administration of deferral or loan programs might prove cumbersome.

2. Circuit breakers.

Another alternative would be a property tax "circuit breaker" operating through the Illinois income tax system. Many states, including Illinois, already allow some taxpayers to reduce their personal income tax if they pay property taxes. This could be expanded so that all or a portion of rapid increases in property tax liabilities would be credited against a household's state income tax. Of course, this would shift the burden of the property tax to income taxpayers. However, an advantage of this system is that the size of the income tax credit could easily be made to vary with household income. Households able to absorb increased property tax payments would be ineligible for the credit. Low-income households that might face a severe liquidity crisis because of the increased property taxes would be given income tax reductions (or refunds, if necessary) to assure that increased property taxes would not force them from their homes. Because this credit could appropriately be targeted by need, its cost would be relatively small.

3. Annual increases in assessments.

The triennial assessment cycle results in big one-time increases in values and the corresponding "reassessment shock" can fuel resentment even with modest rates of appreciation. The good news that assessments don't increase in years one and two is overshadowed by the bad news of a big increase in year three. Currently the Cook County Assessor is precluded from smoothing assessment changes by assigning inflationary increases across all properties in non-reassessment years. One of the attractive features of the assessment cap is smoothing inherent in spreading increases over several years. Take for example a property with three-year appreciation of 21 percent. Under the 7 percent cap, this property will receive assessment increases of 7 percent in each of the next three years instead of all in the first year.

Large jumps in assessments are a problem, and smoothing of year-to-year assessment increases has advantages. It is worth reconsidering allowing the Assessor to make across-the-board increases in non-reassessment years not treated as reassessments for each individual property (with an associated right of appeal).

4. Better information.

As noted, there is a tendency to confuse assessment increases with tax burden increases and to overlook offsetting changes in tax rates. Also, many people perceive tax caps as tax cuts, failing to realize that if total tax receipts by government are unchanged, there is necessarily a *tax shift* to others. Some confusion will always exist, but better information can lead to better understanding of tax policy. The cycle of gathering and reporting information on assessments, tax levies, and tax rates is already very tight, but it might be possible to combine and report some of this information differently. What if a reassessment notice included an estimate of the percentage increase in the tax bill? Perhaps: "The assessed value of your property went up by 'x' percent, but your actual tax bill will depend on the assessed value of all other properties and the total amount of taxes levied by local governments. Given the reassessment of other properties in your district and *assuming* a 3 percent inflationary increase in tax levies over last year, your tax bill would go up (or down) by 'y' percent."

What next?

Cook County's 7 percent assessment cap attempted to soften the property tax impact of substantial appreciation for some homeowners by shifting the burden to other taxpayers. The cap protects many for whom the would-be burden is modest, especially viewed against their increasing wealth. We encourage attention to alternative policy changes that might be better targeted to the objectives. For those with significant cash-flow problems, loans against increased property value might be more appropriate. If ability to pay is the issue, a circuit breaker administrated through the state income tax, targeted to those with low incomes and high property tax burden, could be considered. To the extent that abrupt changes caused by the triennial cycle are a problem, there may be ways to smooth the changes for all, not just those with large rates of appreciation. Finally, ways of better informing the public as to how the property tax is calculated—in particular the difference between the change in one's assessed value and the change in one's property tax bill—are plainly desirable.

"There is tension between what is advisable and what is politically feasible. Many policies we mention may be considered desirable but too hard to implement or get passed in the short term."

There is tension between what is advisable and what is politically feasible. Many policies we mention may be considered desirable but too hard to implement or get passed in the short term. We urge, nonetheless, that targeted deferral, circuit breakers, annual increases in assessments, and better information be given careful consideration in the legislative process.

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