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Policy Brief

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GREGOIRE CALLS SPECIAL SESSION TO REFLY I-747

BRIEFLY

On November 29, the Washington legislature will meet in special session to consider several pieces of property tax legislation.

(A post-session update appears on page 3.)

On November 29, the legislature will hold a special session that is expected to deal with the issue of property tax reform. Governor Gregoire called the one-day session after the State Supreme Court invalidated voter approved Initiative 747 on November 8; six years after voters approved it. The session is intended to ensure that local governments keep their 2008 property taxes within the one percent cap specified under I-747.

INITIATIVE 747

Over the years there have been many attempts to limit the growth in property tax revenue. In 1971, property tax levies of local taxing districts were limited to 106 percent of the previous years revenue plus the percentage growth in the districts assessed valuation due to new construction. In 1979 this statute was expanded to include the state levy. Referendum 47, passed by the legislature and approved by voters in 1997, generally limited the growth of regular property tax levies to the lesser of 106 percent of the previous year's levy or inflation (the implicit price deflator). Initiative 722 was approved in 2000 with nearly 56 percent of the vote and reduced the levy limit from 106 percent or inflation to 102 percent or inflation. However, I-722 was ruled unconstitutional in 2001. That same year, I-722's supporters put I-747 on the ballot, which passed with more than 57 percent of the vote. I-747 limited levy growth to the lesser of 101 percent or inflation. Now, six years after it's passage, the court has also invalidated I-747. The legislature is expected to reinstate the "101 percent or inflation" cap during the special session.

REVENUE GROWTH CAP

It is important to recognize that the 101 percent property tax revenue limit contained in I-747 restricts the total property tax revenue that any taxing district can raise. It does not restrict the taxes levied against a particular property and it applies only to regular, but not special levies.

With the revenue growth cap individual taxpayers may be affected quite differently. The tax rate may increase or decrease to generate the revenue allowed under the limit, subject to other limitations, and the effect on individual properties will vary depending on changes in assessed valuation in the taxing jurisdiction as the following illustration demonstrates.

Consider a simple district, which has a tax rate of $5 per $1000 of assessed value and encompasses just three vacant lots, each worth $1000. The total annual tax revenue for the district would be $15; each owner would pay $5. Imagine that one year, call it year 1, the market value of one of the lots—lot A—doubles, while the values of the other two lots—B and C—are unchanged. The owner of lot B, however, constructs a house worth $1000. For year 2, the district's assessor will revalue both A and B from $1000 to $2000. But since in any year the taxes paid on a property depend upon the previous year's assessment, taxes paid in year 2 will still be just $5 for each property. In year 3 the increased assessments would first affect taxes. Without the 101 percent limit, the annual taxes on both A and B would jump di-

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The Other 1 Percent Limit

The existence of two distinct 1 percent limits on property taxes is often a source of confusion. The first limit, Initiative 747, limits the annual growth in regular property tax revenues for each taxing district to 1 percent; the second limit, built into the state constitution, caps regular property taxes at 1 percent of a property's value.

This constitutional limit means the total of all taxes collected by the state and local taxing districts cannot be more than $10 per $1000 of assessed value unless they are voter approved. The $10 is divided up between taxing districts and the state through a complex web of statutes with the state receiving the largest share. Taxes within this 1 percent limit are called regular levies; whereas levies outside the 1 percent limit are known as excess or special levies. Examples of special levies include local school operations levies and levies to pay interest and principle on bonds.

rectly to $10 and the district's total revenue would be $25. With the 1 percent limit the increase is spread out over a number of years.

Year 3 taxes are limited to 101 percent of year 2 taxes, or $15.15, plus the tax of $5 per $1000 applied to the value of the new construction, an additional $5. Thus the 101 limit means that the district can only collect $20.15 in total revenue in year 3. To achieve that revenue with a tax base of $5000 requires a tax rate of $4.03 per $1000. Owners A and B each pays $8.06, while C pays $4.03.

The important thing to recognize is that the 101 percent limit applies to the total tax received by the district, not the tax paid by any one property owner. In this example, the taxes paid by A and B rose by 61.2 percent, while the tax paid by C fell by 19.4 percent.

The next year the taxes for each owner would be 1 percent higher, $8.14 for A and B, and $4.07 for C. Not until year 25 would taxes reach $5 per $1000 of assessed value. In the real world, though, property values are likely to change again before the full adjustment is reached.

Deferrals

The second bill lawmakers are expected to discuss during the special session is an expansion of the property tax deferral program currently available for retired seniors. Presently, homeowners above the age of 59 with household income below $40,000 can defer payment of property taxes. These deferred taxes are due when the home is eventually sold, or when the property ceases to be the permanent residence of the homeowner or a surviving spouse. The new proposal would expand this program to allow tax deferrals for all families earning less than the state median income ($56,807). Details are sketchy as we write, but it appears that under the expanded program, qualifying homeowners could defer 25 percent of their taxes, up to 80 percent of home value, until such time as the property is sold. The state would reimburse local governments for deferred taxes to hold them harmless from this program. The financial impact on the state in 2009 is said to be $3.5–$4.0 million. The interest rate on deferred property taxes would be indexed to federal rates, implying a 7 percent rate at current market conditions.

Discussion

The opponents of I-747 who took the measure to court, now find themselves at a classic "won the battle/lost the war" moment, as the governor and legislative leadership rush to undo the supreme court's decision and give the state what a majority of the voters voted for.

Six years ago, we observed that I-747 raised three public policy concerns:

> First, by adopting a limit below the rate of inflation, the initiative may lead local officials to pursue other revenue options (impact fees, B&O taxes) that will negatively impact the business climate.

Update

On Thursday, November 29, in a special 12-hour session, state lawmakers reinstated the one percent property tax cap along with a property tax relief bill aimed at low and moderate income tax payers.

The final votes were 86-8 in the House, and 39-9 in the Senate. As expected, the 1 percent limit passed the legislature with no significant changes. The property tax relief bill was passed allowing a tax deferral on up to 50 percent of a qualifying homeowner's property tax bill. It was initially expected to allow a 25 percent deferral.

A major topic of debate during the session was the "banked" capacity local governments have accumulated in unused taxing authority. The state estimates local taxing districts statewide have about $108 million in unused taxing authority. This banked capacity could allow some local districts to increase their levies by more than one percent.

The legislature is expected to take a more comprehensive look at property taxes when it convenes for the regular session in early January.

The arbitrary limit on property tax collections would have differential impacts on local government, affecting those communities without a diversified revenue base most directly. As well, with the state budget already experiencing the effects of the economic downturn, the loss of property tax growth would certainly increase the pressure in the next legislative session.

Second, cities and counties generally spend most of their budgets on infrastructure and public safety – streets, roads, sewers, police and fire services, courts and jails. As budgets tighten, the shortfall in infrastructure finance may well be exacerbated as constrained resources are channeled to important public safety functions.

Third, the initiative again raises the issue of the degree to which voters should give explicit approval to all tax increases. The tight I-747 cap would most likely result in more budget decisions being referred to the voters. Such direct democracy has in recent years weakened the legislative budget process, as popular proposals are presented out of context (e.g., raising teacher salaries, reducing class sizes), leaving the ramifications to be resolved by lawmakers with limited discretionary authority. (WRC 2001a)

These concerns remain (and the reference to an economic downturn may be particularly relevant).

Six years ago, after the courts initially declared I-722 unconstitutional, there might have been an opportunity for the legislature to craft a better limit on property taxes. But, politically, that moment has past. Today, anything short of one percent would be too little, too late.

Debate on property tax reform is unlikely to end at the adjournment of the special session. In the Senate, at least, some legislators have indicated a desire to pursue, in the upcoming session, a more fundamental restructuring of the state's property tax system targeting tax relief specifically at homeowners. In the past such desires have led to proposals to split the property tax roll so as to tax business property at a higher rate than residential property. This is troublesome. As we have said often in the past, non-uniformity in the taxation of property, particularly real property, can hurt business and sap economic vitality. (WRC 2001b).

References

Washington Research Council (WRC). 2001a. "Initiative 747 Cuts Close to the Bone." PB 01-24. October 2.

———. 2001b. "Property Taxes: Uniformly Low is the Way to Go." PB 01-4. February 23.