Assessed Value Cap Overview

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I. Introduction

The property tax has always been an important source of local government revenue. One reason is its relative stability and predictability compared to other types of tax revenue. Also, the property tax is primarily based on real property, which is relatively easy to discover, because it can be found on assessment maps or geographic information systems.

As long as there is any type of tax, there will be discussions of the fair distribution of the tax burden. The International Association of Assessing Officers promotes use of current market value for property assessment:

To maximize fairness and understandability in a property tax system, assessments should be based on current market value of property (IAAO 2010, 4.2).

In a dynamic economy, property values constantly change. Values in one area may increase, whereas those in another may decrease or stabilize. Property taxes then shift to areas with increasing wealth as measured by property value. Only a system requiring current market value acknowledges these changes in local economies and the distribution of property-related wealth (IAAO 2010, 4.2.1).

The taxpayer's ability to predict and afford the property tax is at the heart of good property tax policy (see Appendix A, "Overview of California Proposition 13"). However, the use of current market value as a tax base does not always adequately address predictability and affordability. Thus, many states have implemented tax caps (see Appendix B, "Summary of Assessed Value Caps by State"), since they directly relate to these core issues. These caps generally have taken three forms: assessed value cap, rate cap, or levy (budget) cap.

Assessed value caps limit the amount that an assessed value can increase in a year, often expressed as a percentage increase limit referencing the previous

year. Rate caps limit the amount that the tax rate may increase from one year to the next. Levy (budget) caps limit the amount that the levy may increase per year. A levy is the amount of revenue that taxing jurisdictions must raise from property taxes to meet expenses after taking into consideration revenue from all other sources.

The relationship between the levy, the assessment, and the tax rate is important. This relationship may vary depending on how the nominal tax rate is set. In a rate-based system, the tax rate is set by legislation or governmental authority. Thus the changes to the total budget are dependent upon the change in assessed value:

Levy or budget =
legislated rate x taxable value

In a budget-based system, the tax rate is allowed to change in tandem with the assessments in order to meet the required budget regardless of the assessment level:

Rate = levy or budget ÷ taxable value

Any assessed value cap or limit on the assessment, tax rate, or levy has predictable consequences that affect the distribution of the property tax burden. One group of property owners has to pay an increased tax burden if another group of property owners is allowed to pay less than they would have had to pay if there were no cap in place. Often the biggest beneficiaries of tax caps are property owners whose properties increase in value due to external market forces at a rate greater than the market rate.

II. Examples of the Tax Shifting Effects of Assessed Value Caps

As a result of changing economic conditions, real property market value changes are not uniform across all properties within a jurisdiction. For a substantial number of properties, this can result in the unintended consequence of being adversely affected by the assessed value

limits intended to assist them. This is the result of different properties increasing in value due to external market forces — some increase at a rate greater than the assessed value cap; others increase at a rate less than the assessed value cap; and still others decrease in value due to external market forces. Properties that increase in value due to external market forces at a rate greater than the assessed value limit or cap rate receive favorable treatment from the cap, while properties that increase in value due to external market forces at a rate equal to or less than the assessed value limit or tax cap receive unfavorable treatment. The assessed value cap generates a *lower* effective tax rate for properties that increase in value due to external market forces at a rate greater than the assessed value limit and a *greater* effective tax rate for properties that increase in value due to external market forces at a rate equal to or below the assessed value limit.

To demonstrate this effect, consider an example of a jurisdiction with three properties, each of which begins with the same assessed value. The legislature has set a 3 percent annual cap that limits the increase in assessed value for individual properties. Assume that Parcel A increases in value due to external market forces at 5 percent per year for 5 years; Parcel B increases in value due to external market forces at the same rate as the assessed value limit (3 percent per year) for 5 years; and Parcel C decreases in value due to external market forces at a rate of 5 percent per year. For the rate-based system, it is assumed that the nominal tax rate is a constant 2.00 percent of assessed value and the market value is the same as the assessed value in the first year. It is also assumed that if there were no assessed value cap, the assessed value would equal 100 percent of market value.

A. Rate-Based Example
Table 1 and Figure 1 show the effects of the assessed value limit on the effective tax rate and the tax savings for a rate-

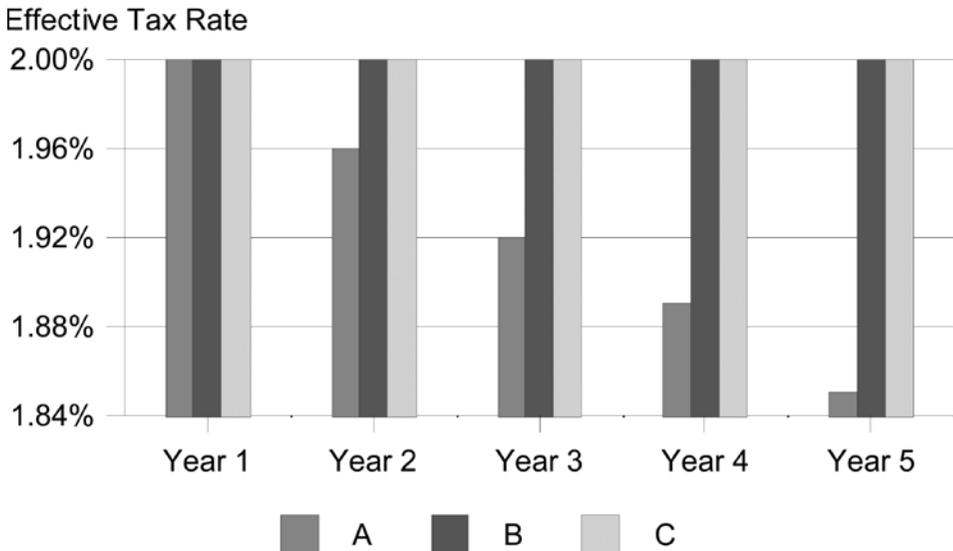based tax system using a tax rate of 2.00 percent of the assessed value.

Without assessed value caps, all properties would pay the same 2.00 percent effective tax rate. However, as the example shows, only Parcel A is increasing in market value at a rate greater than the 3 percent assessed value limit. Parcel A increases in market value from $200,000 to $243,101 for the 5-year period. As a result of the assessed value limit, Parcel A receives a lower effective tax rate and increasing tax savings every year. Parcel B increases in value due to external market forces at the same rate as the assessed value limit and pays the same taxes as Parcel A. Parcel C decreases in value due to external market forces over the period and loses substantial value. Both Parcel B and Parcel C retain the same actual and

Table 1. Effect of assessed value cap on effective tax rate in a rate-based system

Year	Parcel	Market Value	Capped Assessed Value	Taxes		Effective Tax Rate (%)	Tax Savings from Cap	
				Without Cap	With Cap		Dollars	Percentage
1	A	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
	B	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
	C	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
2	A	$210,000	$206,000	$4,200	$4,120	1.96	80	1.90
	B	$206,000	$206,000	$4,120	$4,120	2.00	0	0.00
	C	$190,000	$190,000	$3,800	$3,800	2.00	0	0.00
3	A	$220,500	$212,180	$4,410	$4,444	1.92	166	3.76
	B	$212,180	$212,180	$4,244	$4,244	2.00	0	0.00
	C	$180,500	$180,500	$3,610	$3,610	2.00	0	0.00
4	A	$231,525	$218,545	$4,631	$4,371	1.89	260	5.61
	B	$218,545	$218,545	$4,371	$4,371	2.00	0	0.00
	C	$171,475	$171,473	$3,430	$3,430	2.00	0	0.00
5	A	$243,101	$225,102	$4,862	$4,502	1.85	360	7.40
	B	$225,102	$225,102	$4,602	$4,502	2.00	0	0.00
	C	$162,901	$162,901	$3,258	$3,258	2.00	0	0.00

Figure 1. Effect of assessed value cap on effective tax rate in a rate-based system

effective tax rates and therefore receive no benefit from the assessed value limit over the entire 5 years.

B. Budget-Based Example

By using the same example, Table 2 and Figure 2 show the effects of the assessed value cap in a budget-based tax system.

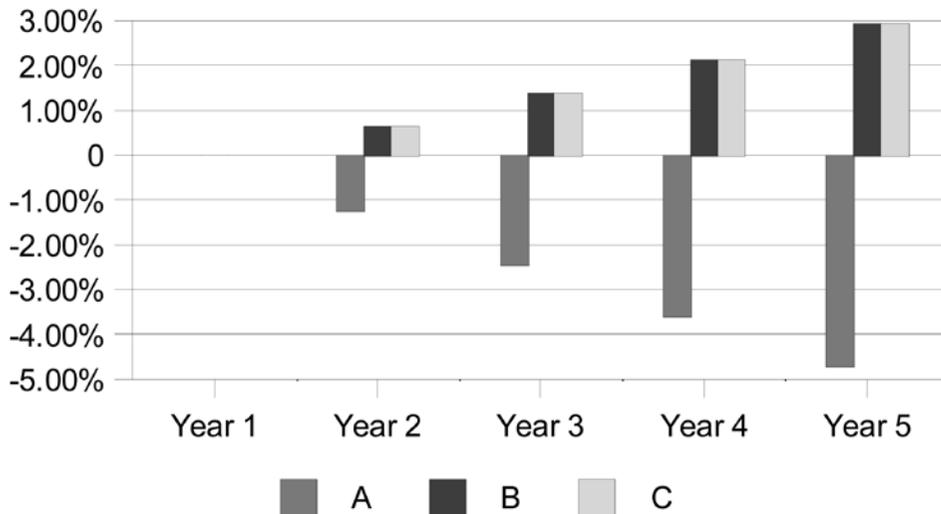Without assessed value caps, the assessed value is the market value of the property and all properties pay the same effective tax rate. However, as the example shows, only Parcel A, which is increasing in market value at a rate greater than the 3 percent assessed value cap, receives a lower effective tax rate. While Parcel A enjoys tax savings because of the assessed value cap, Parcel B and Parcel C experience additional tax increases. As a consequence, the tax burden shifts from Parcel A to Parcels B and C.

Caps aid in making future tax billings predictable, regardless of whether the jurisdiction uses a rate-based or a budget-

Table 2. Effect of assessed value cap on effective tax rate in a budget-based system

| Year | Parcel | Market Value | Capped Assessed Value | Taxes | | Effective Tax Rate | Tax Effect of Cap | |
				Without Cap	With Cap		Dollars	Percentage
1	A	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
	B	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
	C	$200,000	$200,000	$4,000	$4,000	2.00	0	0.00
2	A	$210,000	$206,000	$4,158	$4,106	1.96	−52	−1.25
	B	$206,000	$206,000	$4,079	$4,106	1.99	27	0.66
	C	$190,000	$190,000	$3,762	$3,787	1.99	25	0.66
3	A	$220,500	$212,180	$4,315	$4,210	1.91	−106	−2.45
	B	$212,180	$212,180	$4,152	$4,210	1.98	57	1.38
	C	$180,500	$180,500	$3,532	$3,581	1.98	49	1.38
4	A	$231,525	$218,545	$4,470	$4,309	1.86	−161	−3.59
	B	$218,545	$218,545	$4,219	$4,309	1.97	90	2.13
	C	$171,475	$171,475	$3,311	$3,381	1.97	71	2.13
5	A	$243,101	$225,102	$4,622	$4,406	1.81	−217	−4.69
	B	$225,102	$225,102	$4,280	$4,406	1.96	126	2.94
	C	$162,901	$162,901	$3,097	$3,188	1.96	91	2.94

Figure 2. Effect of assessed value cap on effective tax rate in a budget-based system

based tax rate system. However, assessed value caps shift the tax burden to properties whose market values change at a rate less than or equal to the cap limit. This often reflects the market value change pattern of the majority of the properties. Regardless of the methodology for determining the tax rate, as Parcel A benefits, Parcels B and C carry a larger and larger proportion of the tax burden.

C. Support Based on Recent Data

The State of Minnesota recently allowed its limited assessed value cap system to expire. One of the reasons cited for this was the net tax increases on a substantial number of properties (particularly residential homesteads) that were among the intended beneficiaries of the assessed value cap legislation.

> *This seemingly counter-intuitive result occurs because the limitation on these residential homestead properties was overwhelmed by proportionately larger limitations on other properties.* (Minnesota Department of Revenue 2009, 13)

These findings are also supported by a recent study of two large counties in Idaho titled, "Effects of Taxable Value Increase Limits: Fables and Fallacies" (Dornfest 2005).

III. Consequences of Assessment Limits

Assessment limits protect taxpayers owning properties that have rapidly increasing market values at the expense of taxing district revenue or taxpayers owning properties with decreasing values or with more limited increases. The tax shifting that occurs tends to be invisible to those who pay more because they cannot determine what their taxes would have been without the assessment limit. As with exemptions, there is a smaller tax base, which leads to higher property tax rates, which in turn tend to lead to more pressure to reduce a major funding source for local governments.

A. School Funding

Property taxes represent approximately 65 percent of local school revenue. Because of requirements to provide an adequate level of education for all citizens, regardless of whether they live in property-rich or -poor school districts, states typically equalize school funding, adding state funds when sufficient local funds are not available. Assessment limits artificially distort this system. If constrained value is used to equalize school funding, districts with large market value increases may appear poor and may receive larger shares of state funds, despite more market value wealth. If full market value is used to equalize school funding, school property tax rates may be disparate, giving the impression of unequal treatment. School bond ratings may also be affected, since, given constrained values, there is less wealth to support bond repayment.

B. Predictability

Assessment limits appear to produce more predictable property taxes; however, this is an illusion. Property tax predictability is dependent on several factors, including the relative rate of value change between properties and the underlying systems that control property tax rates and taxing district budgets. A system that constrains assessed value increases but does not address revenue issues or allows tax rates to rise freely merely decouples the tax from current market value without necessarily providing predictability. California's Proposition 13 based system may create greater predictability for current owners because both assessed values and overall tax rates are constrained.

C. Transparency

Current market value allows for a more open system with checks and balances. It is easier for the public to understand current market value and to appeal assessments that appear to be in excess of market value. Similarly, the revenue sys-

tem should include limits to prevent revenue windfalls resulting from changes in market value. Revenue accountability may be further promoted by "truth in taxation" public notice provisions requiring special, highly visible notices to taxpayers of proposed tax rate or budget increases.

D. Capped Values Paradox in Declining Markets

When economic downturns result in decreasing market value, caps that have been in place for several years may prevent capped assessed values from decreasing. Assessed (taxable) values may continue to increase when, despite the downturn, the capped assessed value is still below the current market value. Assume, for example, a property with a market value of $200,000 in 2005 would have experienced a 10 percent annual increase in market value to $266,200 (compounding the increases) in 2008. However, a 3 percent annual assessed value cap limited the taxable value to $218,545 (rounded) in 2008. Then, in 2009, the market value decreases 10 percent due to external market forces. The new market value would *decrease* to $239,580 ($266,200 × 0.90), while the 2009 assessed (taxable) value would *increase* to $225,100 [$218,545 × 1.03 (rounded)]. Taxpayers in the situation outlined in this example often see increasing assessed (taxable) values and, quite possibly, higher property taxes. These effects are all related to the caps, which eliminated clear linkage to current market value as a basis for the property tax.

E. Mobility

Assessment caps create a more stable and predictable property tax for long-term owners. Most cap systems also return property to current market value when it sells. Such a capping system therefore typically shifts taxes based on length of ownership from long-term owners to newer owners. This can cause long-term owners to feel trapped in their property because they either cannot afford to, or do not want to, lose their tax advantage and can discourage them from selling if they were going to buy another property. At the same time, the assessed value increase to market value discourages potential buyers, especially first-time buyers. If the assessment cap also applies to business property, businesses may become more inefficient, because the same mobility penalty may cause some of them to stay longer in less suitable properties.

IV. Suggested Alternatives

Because current market value is not entirely predictable from year to year, homeowners may be unable to plan for or accommodate tax shifts from assessed value increases not directly related to an individual's ability to pay taxes. Safety nets that provide targeted property tax relief can be made available. The most common safety nets are circuit-breaker and tax deferral programs. Circuit-breaker programs provide grants or credits that apply to or are based on property taxes and phase out as income increases. These are more popular because benefits are not repaid. Tax deferral programs allow property taxes to accrue without penalty or threat of loss of property for the current owner. However, the accrued taxes (and usually interest) constitute a lien, all or part of which must be satisfied eventually.

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Appendix A. California Proposition 13 Overview

California's Proposition 13 and its companion referendum Proposition 8 amended state constitutional law and fundamentally changed the property tax system. Proposition 13 was intended to protect taxpayers from unanticipated increases in property taxes, to provide effective tax relief, and to require voter approval of tax increases. Proposition 13 passed with 65 percent of the vote in 1978 and continues to have widespread support of California voters. The forces behind the change were high real estate inflation rates and equally high increases in property taxes. According to a report published by the Lincoln Institute of Land Policy, *Property Tax Limits; Lessons from Thirty Years of Experience*, leading up to Proposition 13, "many homeowners in California faced annual increases of 30 percent or more in their tax bills" (Haveman and Sexton 2008, 5). The success of the Proposition 13 initiative shifted the control of state and local government revenue from tax administrators to the voters. Because the movement wanted bipartisan legislative support for any tax increases, all state and local tax increases now require a two-thirds vote instead of the pre-Proposition 13 majority vote.

The mechanics of Proposition 13 are codified in Section 2 of Article XIIIA of the California Constitution, which established an acquisition value assessment system. All assessments were frozen at 1975–1976 levels. Property is reassessed at market value only when transferred through a change of ownership or by new construction. Thereafter, the taxable value may increase annually by no more than the rate of inflation or 2 percent, whichever is less. Certain transfers do not qualify as re-assessable events, such as family sales. Sale price may or may not reflect market value as determined by the assessor. California has one of the most stringent rate-based property tax systems in the United States. Tax rates are limited to 1.0 percent of assessed value, excluding payments for pre-existing indebtedness.

Because of the value increase limit of 2 percent annually for all non-selling property, over time the tax burden has shifted to owners of recently purchased property. Whether this shift in the tax burden was intended or unintended, it creates disparity in assessments between property classes and inequity within similar property classes relative to market value. However, because Proposition 13 amended the California state constitution, the assessment disparity is constitutional.

The companion initiative, Proposition 8, allows for value reductions, but even widespread reductions in real estate values have a muted effect on assessment rolls because properties that have not transferred for years are assessed less than current market value. "Because many properties are already assessed at well-below-market prices, if actual selling prices decline, the effect on tax bills will be muted," according to a Standard & Poor's report issued in 2007, describing the "Proposition. 13 cushion" (Saskal 2009, 14). If assessments are lowered due to reduced sale prices, a new base for future (limited) assessed value increases is established. If assessments are reduced due to general market conditions, they are considered temporary reassessments, which can be recaptured to previous levels.

Another impact of Proposition 13 that is more pronounced in California but has spread across the country has been the creation of user fees outside the tax system. User fees have become a much more significant revenue source for state and local governments in general and for local governments in particular. Such fees generally are not subject to voter approval and, unlike property tax assessed values, cannot be appealed.

Appendix B. Characteristics of
Property Tax Assessment Limits by State, 2007

State	Coverage	Eligible Property	Assessment Limits	Caps Removed upon Sale?	Individual Parcel Value or Aggregate Assessment?	Limits and Qualifications
Arizona	statewide	all	X	no	individual	greater of 10% or 25% difference between last years limited value and current market value
Arkansas	statewide (constitutional)	all	X	yes	individual	homestead 5%, other 10%
California	statewide (constitutional)	all	X	N/A	individual	lesser of 2% or inflation
Colorado	statewide (constitutional)	residential	X	N/A	statewide aggregate	residential assessment limited to 45% of state total
Connecticut	local option	all	X	yes	individual	phase-in, at least 25% per year
District of Columbia	district-wide	homestead	X	yes	individual	10%; 5% for qualifying low income
Florida	statewide (constitutional)	homestead	X	yes	individual	lesser of 3% or inflation
Georgia[a]	local option (local constitutional)	homestead	X	yes	individual	freeze (0%)
Illinois[b]	local option	homestead	X	yes	individual	7% with maximum exemption value of $33,000
Iowa	statewide	residential & agricultural	X	no	statewide aggregate	4%
Maryland	statewide	homestead	X	yes	individual	10% statewide for state property taxes; local options for local taxes range from 0% to 10%
Michigan	statewide (constitutional)	all	X	yes	individual	lesser of 5% or inflation
Minnesota[c]	statewide	farm, residential, seasonal residential	X	no	individual	greater of 15% or 33% of difference between last year's limited value and current market value
Montana	statewide	all	X	yes	individual	16.66%/yr phase-in of reassessment over 6 years
New Mexico	statewide	residential	X	yes	individual	3%
New York	New York City & Nassau County	residential with 10 or fewer units	X	no	individual	6% (residential up to three units) or 8% (other residential) per year; 20% or 30% over 5 years
Oklahoma	statewide (constitutional)	all	X	yes	individual	5%
Oregon	statewide (constitutional)	all	X	no	individual	3%
South Carolina	statewide (constitutional)	homestead	X	yes	individual	15% over 5 years
Texas	statewide (constitutional)	homestead	X	yes	individual	10%

Source: Lincoln Institute of Land Policy Report: Property Tax Assessment Limits—Lessons from Thirty Years of Experience, p. 11, table 1, reprinted with permission. The full report can be downloaded at http://www.lincolninst.edu/pubs/1412_Property-Tax-Assessment-Limits.

[a] Since this chart was prepared by the Lincoln Institute *of Land Policy*, the Georgia legislature has passed HB 233, which places a three-year moratorium on value increases in Georgia.

[b] *The Illinois legislature began phasing out its assessed value cap in 2007.*

[c] *Since this chart was prepared by the Lincoln Institute of Land Policy, the Minnesota legislature has allowed its tax cap legislation to expire.*