Rhode Island Policy Reporter

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Taxing Matters

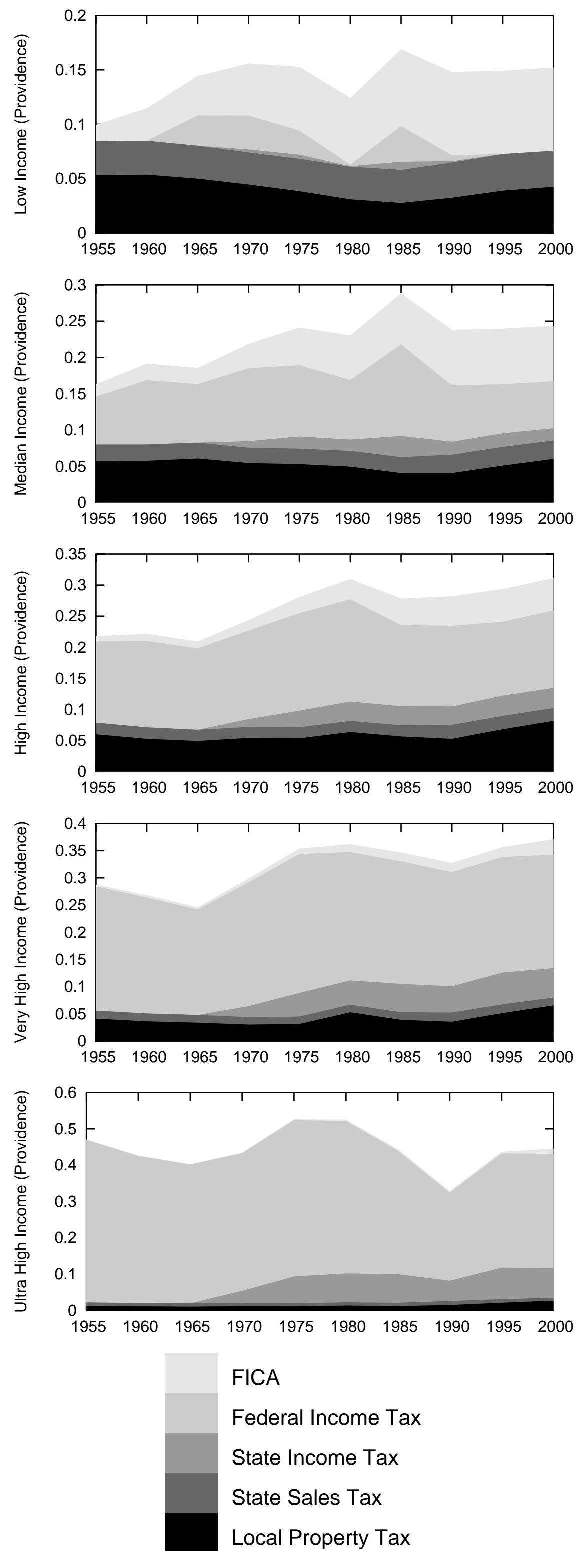
WE HEAR A LOT OF NOISE about property taxes in Rhode Island. They're said to be too high, we rely on them too heavily and so on. But what does this mean? And what about the state income tax and the sales tax? Taxes are a subject so obscured by clouds of rhetoric that they demand examination by the sunshine of some data. With that terrible metaphor ringing in our ears, **RIPR** has begun a study of historical tax rates in Rhode Island over the past fifty years, and we have some early results to offer.

The accompanying figures show the proportion of income paid in taxes by imaginary but statistically typical families of four earning various multiples of a town's median income. The low income family was specified to be earning half the median income for that town, and the high income families earned two, five, and twenty times the median income, respectively. Using data from the IRS, the Census Bureau, and local tax assessor's offices, we calculated the burden of five taxes: the Social Security and medicare payroll tax (FICA), the federal income tax, the state income tax, the state sales tax, and the property tax.[1] The calculations were done at five-year intervals, starting in 1955 for different towns. At right are the results for Providence, and inside you can find the charts for North Kingstown, the first two towns completed.

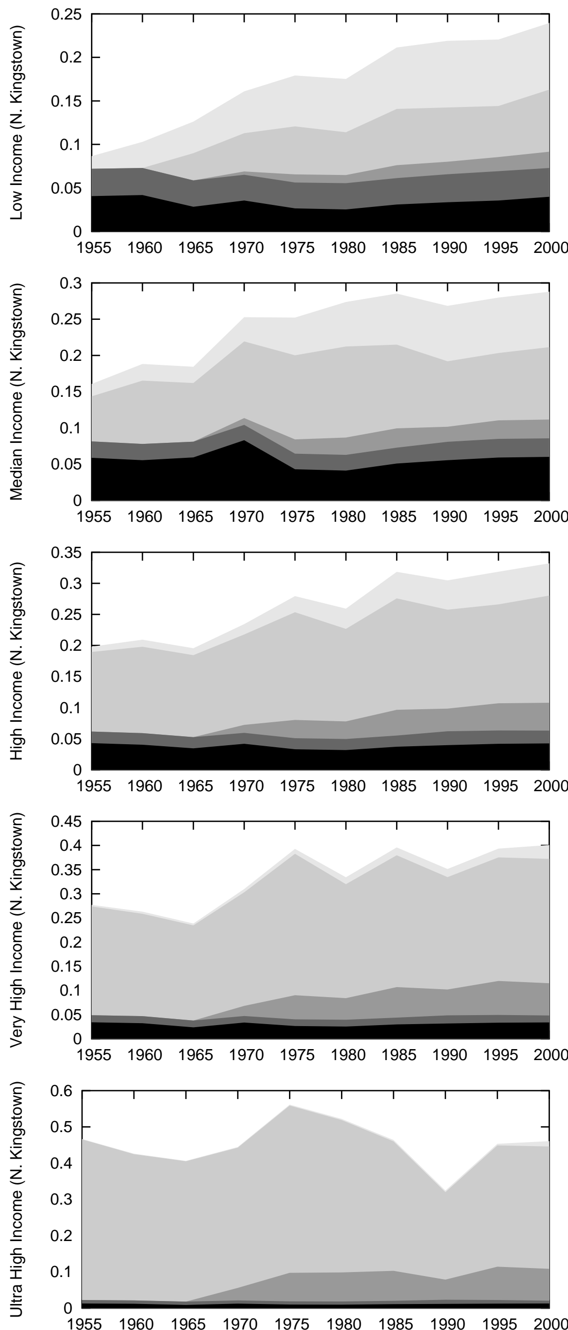
First, a set of disclaimers. When this study was begun, the latest year for which good data were available was still before the Bush tax cuts took effect (and the bulk of them won't take effect for a few years more, anyway). Some of that is available now, but we're going to save that discussion for a hypothetical future issue. This project was undertaken as a vehicle for approaching problems of state and local policy.

Furthermore, this is not a complete picture. For example, available data about the value and distribution of automobiles is not very good (the census asks about rent, but not about cars), and so the property tax on them has been omitted from the comparisons. For that matter, we've also omitted the gas tax, and confined ourselves to the questionable assumption that the upper brackets own only one house. But the taxes that are included in the comparison are the important ones, the ones that make up a significant fraction of most families' expenses.

So what's interesting about these pictures? For one thing, though the 1950's and 1960's saw a rise in the overall tax burden of most of these brackets, after that the upward pressures seem to have eased. Only a few of them rest today at levels significantly different than where they were in the mid-1970's, twenty-five years ago.



[1]For the suspicious or the curious, methodology notes can be found at *whatcheer.net/ripr*.



FICA The most dramatic rises in tax burden over the years are apparent at the lowest income brackets. Someone earning half the median income in Providence (the median income in Providence was about $32,000 in 2000) pays about 15% of their income in taxes, up from slightly less than 10% fifty years ago. *All* of this increase is attributable to Social Security and Medicare payroll taxes (FICA). For the median income family, taxes rose from 16% of income to 24%, and three-quarters of that was for FICA taxes.

Until quite recently, FICA taxes were capped at about twice the national median income. That means that a family earning ten times the median income paid the same tax as a family earning twice the median. The Medicare component of the FICA tax has had that cap removed, but the larger Social Security component is still capped. You can see this regressive nature of the FICA taxes by looking at the decreasing fraction of a family's income taken by them. In the upper brackets, the sliver that represents FICA taxes is barely visible.

FICA taxes were raised substantially in the early 1980's, under the last plan to "save" Social Security. Though some of the new money was (probably) needed for benefit payments, most of the increase since then has been used to finance higher-than-necessary deficit spending by the federal government. That is, cuts in the income tax could be financed by loans from Social Security, and no one would know the difference until much later.

Federal income tax Speaking of cuts in the income tax, it's worth noting that the federal income tax falls between 1980 and 1985 on all brackets except the lowest three (two in Providence and one in North Kingstown). These were the years of the famous Reagan tax cuts, of course. It has been noted by many economists that after these tax cuts, federal tax revenue went up. Usually the argument they offer is that the tax cuts themselves caused the economy to rebound. But the paradox of rising revenue in the face of tax cuts seems less paradoxical when it's pointed out that the cuts weren't cuts for everybody.[2]

The other notable feature of this period is the way the tax burden on the upper brackets declined dramatically. For the ultras in our survey, the burden decreased from 46% of income to 24% in 1990. By 2000, it had settled back to about 33%.

Why should we care about the tax burden on the small number of plutocrats among us? They are a small number, but nationally they are responsible for almost a quarter of the taxes collected. Our Rhode Island wealthy apparently don't have blood quite so blue, so the figure is

[2] In fairness to Reagan, it should be noted that we did not calculate the burden in the exact years of the cuts, and there were some adjustments in the immediately following years. But the point still stands that the year after his reelection, taxes were higher on the low income brackets we sampled than they were in the year before his election.

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somewhat lower, but is still almost 20% of the total income tax revenue.

Though the federal income tax is still progressive, it is much less so than it once was. The tax cuts of the early 1980's, and the subsequent reforms in 1986 and after reduced the progressive nature of that tax. In the mid 1970's, the high brackets were taxed at an effective rate of around 46%, and the lowest ones at effective rates between 2% and 6%. In 2000, the effective rate on the upper brackets was down to about 31%. Much of the debate about taxes focuses on "marginal" rates—the rate paid on the last dollar taxed—and in the 1970's, the top marginal rates were around 90%, which sounds awfully high. But it's silly to say that anyone paid 90% of their income in taxes. No one did. Those people paid, as we said, about 46%. And though the top rate in 2000 stood at 39.6%, no one actually paid that much of their income in tax.

Median Income

Year	Providence	N. K.
1950	3,170	2,961
1960	5,257	5,183
1970	8,430	9,002
1980	14,948	22,191
1990	28,342	46,736
2000	32,058	69,559

(source: Census Bureau)

Like all presentations of information as complex as tax incidence, this study has several important caveats. One example is in the federal income tax in North Kingstown. From the charts, it appears that the low income brackets had their taxes escalate dramatically in the 1970's, when what was really happening is that the median income of that town was growing quickly as the town's character changed to the suburban town it is today. This means that where the income brackets shown were comparable to the Providence brackets up to around 1970, after that they diverge dramatically, so that today, the "low" income (half the median) in North Kingstown is more than the median income in Providence.

Property Taxes The big surprise in these pictures seems to be in the layer representing the local property taxes. With all the shouting done about property taxes in Rhode Island, you'd expect to see more dramatic movement in that bottom layer. But as a proportion of income, property taxes in North Kingstown have remained nearly constant for the past fifty years, in all the brackets. In Providence, though there have been real increases in the tax burden over the past decade, the trend has been fairly flat otherwise, and the increases seem quite minor overall. For example, the high income bracket went from paying 6% of their income in 1955 to 8% in 2000. Of course the fraction had declined to 5.3% in 1990, so it felt slightly more dramatic than it was. Still, it's hard to characterize this as the "runaway growth" of municipal budgets we hear about. Even in Providence, the growth in residents' incomes seems to have more or less kept abreast of the growth in the municipal budget.

Editor's Note

This is the second in a series of regular (more-or-less monthly) reports about state and federal policy issues that affect life here in the Ocean State. Each report focuses on particular policy areas of interest. Subsequent issues will examine controversial aspects of environmental policy, health care, property tax reform, and education spending. You can see issue one, a dissection of the state budget, online at *whatcheer.net/ripr*. The intention is to focus on what the actors in these policy arenas are actually doing, rather than what they're saying about it.

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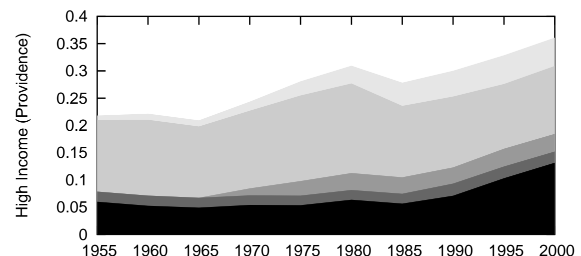
But Providence taxpayers are famously oppressed, and even North Kingstown has a "Taxpayers' Organization" that annually pressures town officials into cutting the school budget by citing its fears of "runaway growth." How do we reconcile this with the statistical findings?

The answer is that no one is a statistic. Few people ride the same income percentile for their whole lives, though many stay in the same one for years at a time. People have good years and bad ones, and good decades, too. But while they're riding up and down, they tend to live in the same house. And whatever the variation in their income, the property tax is consistent one year to the next. And it's consistently rising.

If we readjust our pictures to specify that our typical family live in the *same* house over the span of the study, the curves look somewhat different. This is a usually inadmissible confusion of statistics and specifics, but it might give a better flavor of what any real family actually experiences. So here's what it looks like for our high-income family from Providence, had they happened to live in a house on the East Side.



Now it looks more like what people complain about.

Unlike other taxes, the property tax is not just be-

tween the taxpayer and the government. The property tax admits the marketplace to the relationship, using the market values of people's houses to set their taxes. And the market occasionally looks with favor on this or that neighborhood, raising the taxes in the neighborhood beyond the capacity of the current residents to afford them. While the median property—somewhere in the city—may still be affordable to the median-income homeowner, this doesn't help the median-income homeowner who's just been told he now lives in a much tonier neighborhood than he can afford. Thus every revaluation vaguely resembles a lottery where homeowners may or may not be suddenly deemed too poor to live in their own homes.

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Beyond that, property taxes are the only form of taxes we levy on wealth, as opposed to the transfer of wealth. All other taxes, including the sales tax, the estate tax, the income tax, and so on, are levied as a percentage of some exchange of money. The income tax is a percentage of income taken in over a year; the sales tax is a percentage of dollars exchanged in some transaction; the estate tax involves wealth passed to heirs.

The reason for this is the theory behind this tax. Property taxes are levied on the assumption that the value of your house is a proxy for your ability to pay. A more expensive house indicates someone who should pay more tax. It is simpler to assess the value of a house than it is to audit someone's income, and it's harder to hide something like a house. Thus you have a low-overhead tax that is easy to levy, and this is why municipal governments across America are funded this way.

However, this central assumption becomes less sound in a rising real estate market, and breaks down completely in markets such as we've experienced in the early 1980's and the late 1990's. Here, the value of a house is almost independent of a person's income, since the same house could have been bought recently for a high price, or long ago, for what now seems a pittance. With the current methods of assessment, both owners would be subject to the same tax. In essence, there is a fee—imposed by the city—to belong to certain neighborhoods. If you cannot afford the fee, you must move.

The assumptions behind the property tax fail in rapidly rising real estate markets

The result is that neighborhoods tend toward the homogeneous. (Well, they do anyway, but the other reasons are not imposed by the government.) Only people with a certain income can afford to live on the East Side, for example, no matter how long they've been there and how much they've contributed to the rise in values there. Its property is the most valuable, and so the East Side is in the worst situation, but no neighborhood is immune. People who have lived in their houses, kept their yards clean, and been good citizens and neighbors for 30 years are rewarded by being forced to sell their house and move

More Knocks on the Property Tax

Beyond the essential unfairness of the assessment process in a rapidly rising market, there are plenty of other reasons to object to the way Rhode Island municipalities fund themselves. For one, it keeps towns from making sensible land-use decisions. Every zoning decision must be made with an eye to the town's finances, and this is not always the best thing for the town, or the state.

In a world of shrinking open space, the towns that still have it have little incentive beside aesthetics to keep it. Town revenue is made by developing land. There are ample studies (not to mention a huge fishkill in August) that show that it's not that simple, but in the case of a housing development, say, the revenue is short-term and the expenses are long-term. What a surprise that the short term is the winner so often. Plus there is always the possibility of commercial development, with the chance that the workers (and their expensive-to-educate children) will live out of town. So what incentive, aside from sentiment, does Exeter have to remain small? And how strong a force is sentiment, when compared against the need to pay the police?

Town financing questions also complicate questions of placing low-income housing, and—had we a statewide transportation planning process that took mass transit seriously—they would bedevil those planners, too. (Fortunately for those planners, we don't, but more on that in a future issue.) The strength of a town's business districts, the health of its neighborhoods, and the security of its water supply are all routinely compromised to pay the piper.

And still we haven't yet mentioned that the property tax is the single most onerous tax on businesses. At the State House, business income taxes and investment credits are endlessly debated, but they're not the taxes businesses routinely complain about. An income tax never put a business out of business. No income, no tax. But the property tax bills come in good years and bad.

to a neighborhood they can afford. Almost by definition, this is not as nice a place as they came from. We propose the **RIPR** razor as a general guide: Any government policy that has the effect of evicting people from their homes faces a heavy burden of justification.

The property tax is between the taxpayer, the government and the market. If—as we've seen—the problem with property taxes isn't necessarily with the government, it must be with the market. Rather than spending time forcing music programs out of school budgets, people upset about their property taxes should work on regulations and institutions to control the market. The rising real estate market seems like a boon to homeowners, so measures like what follow can seem unpopular, but it is a two-edged sword, enriching some, but impoverishing others whose only mistake is to want to live in their own home. These markets kill neighborhoods.

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What to do about the market? It's easy enough to say that the market is a problem, but once you say it like you believe it, then what? Even if government isn't the whole problem, it's so much easier to pressure a town council by mustering a show of bodies than it is to pressure the real estate market, which is affected by forces much bigger than the state. But weak doesn't mean powerless. Here are some policy suggestions.

Realty Capital Gains Taxes It is probably beyond the power of any state or local government to stop the excesses of the real estate market, but the local market can be dampened. One of the first targets ought to be speculators. In the early 1990's, Vermont enacted a transfer tax on real estate capital gains whose progressive nature depends on the length of time the property has been held. Property held more than six years is not taxed, while the tax on capital gains on property held less than a year is a satisfyingly confiscatory 70%. A tax like this could raise up to $15 million dollars for the state of Rhode Island, although a better outcome would be for it to raise zero dollars, but put a damper on real estate speculation.[3]

Community Land Trusts Another promising strategy could be the community land trust model. A traditional land trust is for holding open space or common land, or development rights to farms. A CLT, though, owns the land under houses. The trust owns the land a house is on, while the homeowner owns the house, and holds a 99-year lease on the land. A condition of the lease is some kind of limit on the gains that can be realized on the resale of the house. Rhode Island has a few of these organizations, the most established of which is Newport's Church Community Housing Corporation, which has been doing this work all over Newport County since 1993. Others exist in the East Bay, South County, Woonsocket, and Providence, though most of these are just beginning. There is a group that promotes and assists these kinds of trusts nationwide: the Institute for Community Economics (*www.iceclt.org*).

CLTs were designed to preserve affordable housing in the face of real estate speculation, and where they are well established, they are doing that job. But at their current non-profit, community organization status, few can do more than nibble around the edges of the larger problems of housing and the real estate market. After ten years of work, Church Community Housing only has around 75 leases. Without the power of government—federal, state, or local—they will continue to be a marginal solution. With that power, though, they could change the face of the state.

For example, suppose you knew that the tax assessment of your house would take into account the fact that lease restrictions mean your house cannot be sold at market value? You might have to forego making a killing at some future date, but you might be able to cut your real estate taxes by a lot today. Many people might find this an appealing bargain, and the result would be a lasting legacy of affordable and desirable housing.

Change assessment strategy If the point behind assessing property is to find an accurate proxy for a household's income, the purchase price may be a more accurate indicator than some arbitrarily assessed "value," which depends on forces far outside that household's control. Whoever owns that house had to buy it, so somehow they managed to raise the money to do so. If one assessed property based on the purchase price, you would have a less volatile, and fairer, system. People's incomes do tend to rise over time, so it would make sense to inflate the purchase price by the Department of Labor's figures for wage inflation each year, or a similar measure. California and Oregon levy property taxes this way, and Georgia allows it as an option for towns.

In addition to avoiding the eviction of poor people from gentrifying neighborhoods, such a system would allow a town to avoid most of the costs of revaluation. These procedures typically cost our towns millions of dollars that could be spent on more important things. These kinds of reforms may not be advisable for commercial real estate, which tends to be owned by immortal corporations rather than people, so towns wouldn't be off the hook entirely, but partial relief of a heavy load is still a relief.

There is a legitimate charge that can be made against systems like this. It is unavoidable that such a system will

[3]Estimate from data from riliving.com and the Census Bureau (1997).

create the situation where neighbors, in similiar houses, pay quite different property tax bills. In fact, this is part of the point. This is often called unfair. But how much more unfair is it than evicting someone from their home because their neighborhood has become too rich for them?[4] All tax systems have inequities. The job of the policy makers is to minimize them where possible, and to choose among them where it isn't.

A transition to such a system could be done in a revenue-neutral way, and though it would not correct existing injustices, it might go far to preventing future ones.

Split tax rates Some of Rhode Island's municipalities might benefit from taxing land and buildings at different rates. In several Pennsylvania cities, for example, land value is taxed at a much higher rate than the buildings on it—sometimes as much as sixteen times as high. The idea is to discourage certain kinds of speculation (such as the stockpiling of vacant buildings that currently plagues downtown Providence) and encourage redevelopment and improvement of urban land. The method can also add a small degree of progressivity to the naturally regressive property tax, since small houses on large lots are more likely to characterize wealthy property owners.

Pittsburgh uses this method, which was enacted in 1913 to tax the deer parks and estates that the steel barons maintained within the city limits. In the 1970's, and 1980's, though, the split rate was rediscovered as a tool in combatting urban blight, and Pittsburgh has been fairly successful at using it. More than fifteen other Pennsylvania cities have adopted the same system.

[4]It is also true that there exist people who think that homogeneous neighborhoods are a good thing. They aren't among my friends, but it would be silly to deny their existence.

What to do? Through the din and smoke that characterize recent wars about taxes, it is sometimes possible to perceive who the real villains are. That is, if your family's finances are feeling pinched, it is an excellent bet that the FICA taxes you pay and the overheated real estate market are more to blame than overspending by your town. Of course it's easier to get a crowd to bring their pitchforks and torches to a town meeting than it is to pressure Congress to do something about FICA tax rates. But these crowds are no different than the drunk looking for his keys under the streetlight because the light is better there.

But this is not to say property taxes shouldn't be lower. The box on page 4 lists several other reasons why the way we fund our local governments needs fixing, and it doesn't even mention school funding disparities or affordable housing shortages. But to reduce our state's reliance on these taxes will require a complete reassessment of (and quite a bit of repair to) the relationship between the state and its towns. This may be a lot to wish for, but what other way is there? ■

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Raison d'Être See p.3. Also pp.1-6.

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