

Education Finance and Property Tax Relief In West Virginia

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Introduction

During the 2006 Legislative session SB 570 proposed changing the method used to determine the local share for school support. While SB 570 passed the Senate it did not reach the floor of the House. The bill was the result of a Legislative Interim Committee study which transpired over the summer and fall. While SB 570 was more comprehensive than a single provision, the one which drew the most comment was to require that over a period of seven years all real property in each county would be assessed at the constitutionally required 60 percent of true and fair market value.

Information presented to the Legislature's Interim Sub-Committee C on Education Finance indicated widespread underassessment of real property. According to the 2005 Sales Ratio Analysis prepared by the Property Tax Division of the Tax Department, the range on residential property was from 39 to 63 percent on residential property. Similar ranges also existed for other types of property. The "typical" assessment level is around 55 percent. There is a reason for this. The Tax Department allows a 10 percentage point variation (five points above or five points below 60) to be considered in compliance.

The current state-aid formula encourages the underassessment of real property. Using the seven step formula the foundation amount to be available in each county for PreK-12 education is determined. From that amount the local effort is subtracted. The remaining "gap" is filled by state appropriations.

By under-assessing real property, local support from property taxes is reduced and state spending for the district increased. The schools do not experience any loss of financial support as the state makes up any difference between local effort and the foundation amount. Counties which assess near or at the required level wind up penalizing their tax payers when compared to those in counties which underassess.

While estimates varied on the amount of state aid that must be given to counties which underpasses, the cost to the State is around \$15 million. This is funding that could be used to increase the foundation level of support for all districts or for other education related expenditures.

The Issue

SB 570 provided that all counties would be brought to the required 60 percent assessment level by steps until all reached 60 percent by the years 2012. Over this seven year period the counties which had the lowest assessment ratios would experience increases in local property taxes which in some cases would be substantial. There are several reasons for the under assessment of real property in West Virginia:

- Failure of assessors to update property values at levels indicated by the market

- Fast growth in property values, particularly residential, in those areas of the State which have seen significant influx of residents from surrounding States.

The argument for not achieving the required 60 percent assessment level was the impact on certain groups of residents. These individuals will see increases in their property taxes on their homes which are a result of the economic growth of the region pushing up property tax values. They may be elderly, disabled, veterans and/or those on fixed incomes. It is contended the increase in property taxes on their homes may leave them with the alternative of leaving their homes or foregoing other essential expenditures.

Alternative Solutions

West Virginia is not the only state which either faces or has faced this problem. Other states have used a variety of methods to mitigate the effect of rising property taxes on these “captive” residents. None of these is perfect, but some are superior to the others. They do present a variety of policy options which the Legislature may wish to consider.

The desirability of these options can be evaluated on the basis of the following criteria.

- What is the impact of the alternative on the ability of the schools and other local governments to provide required services? Alternatives which increase or provide the smallest reduction in local fiscal capacity are to be preferred.
- Does the alternative provide relief to those who are most adversely affected by raising property taxes? Alternatives which “target” relief to those with the least ability to pay are to be preferred.
- How does the alternative affect the balance between local and state governments? Alternatives which cause the least centralization of financial responsibility at the state level are to be preferred.

All states use one or more types of property tax relief. Those considered in this report include:

- Homestead exemptions
- Rate or valuation caps
- Split rolls or tax classifications
- Tax Freezes
- Deferrals
- Acquisition Valuation
- Circuit Breakers

West Virginia uses three: homestead exemptions, rate caps and split roles. It appears that West Virginia places more restrictions on the use of property taxes to support local education than any other state in the nation. The methods used in surrounding states to relieve property tax burdens are provided in Table I and explained in the Appendix.

Table I
Methods of Property Tax Relief
West Virginia and Surrounding States

State	General (no age, income, or other qualifications)	Senior Citizens				Disabled				Veteran	
		Exemption	Freeze	Deferral	Income Limit	Exemption	Freeze	Deferral	Income Limit	Exemption	Income Limit
Kentucky		\$6,500 (1972\$)				\$6,500 (1972\$) if totally disabled					
Maryland	circuit breaker program				yes	\$6,000 if blind				full exemption if totally disabled	
Ohio	10% reduction on real residential + 2.5% if owner-occupied	up to \$5,000			\$23,700	up to \$5,000			\$23,700		
Pennsylvania	local option to exceed half the median AV of all homestead property in the district	rebate up to \$500	local option	local option	\$15,000					full exemption for blind or totally disabled	
Virginia	Local option										
West Virginia		\$20,000 plus \$10,000				\$20,000 if totally disabled				\$20,000 for retired or disabled	

Homestead Exemptions: The most common alternative to provide property tax relief is the homestead exemption which is used in 40 states. Most of these began during the Great Depression when home foreclosures for unpaid taxes were common. Under homestead exemptions the owner is allowed a partial exemption of the assessed value of the individual's primary residence. The exemption usually applies to all property taxes, but in a few states only a subset is covered, usually school levies. Only a few states extend the exemption to all home owners. Most limit it to senior citizens and some include disabled and veterans.

In 14 states the homestead value is a fixed amount of the property's value. These range from \$1,000 to \$150,000. As an alternative, the exempt value is determined as a percentage of market (or assessed) value. The second option has the distinct advantage of increasing the value of the exemption to keep up with rising prices. Fixed dollar amounts deteriorate in value as property inflation takes place unless they are adjusted by specific legislation. For example the current \$20,000 homestead exemption for those over 65 and those disabled in West Virginia was adopted in 1982. To have the same real value today would require an exemption of approximately \$41,500.

Most critics point out that homestead exemptions extended to all home owners are an expensive and inefficient way to help low income individuals. While the fixed dollar approach gives the most assistance to owners of lower value homesteads, the percent system gives the greatest dollar assistance to those in the houses with the highest valuations. Some states have placed income limits or dollar limits on the value of the exemption to mitigate this problem.

This problem is compounded since a significant percentage of lower income individuals rent rather than owning. Estimates from the 2003 American Housing Survey indicate that nationwide 52.8 percent of households with income of less than \$20,000 rent rather than own. For comparison purposes, only 24.8 percent of households with income of \$20,000 or more rent their housing. Some states have responded by providing a "renter's credit" equal to some percentage of rent. These range from 6 to 20 percent of rent paid.

These credits are based on the assumption that landlords pass along all the property taxes to their renters. This is true in tight rental markets, but when rental housing is abundant property taxes are most likely a reduction in the return the landlord receives. The lack of a renter's credit in West Virginia works a particular hardship on the renting poor as the property tax rate for rental property is twice that for owner occupied residences.

The other problem is the erosion of the local property tax base. In West Virginia the homestead exemption reduces property taxes for local education by \$30,000,000. This does not reduce the amount of funding received by the schools under the foundation program as the State makes up for the lost revenue, but it does increase the amount of

State aid that must be appropriated to reach the foundation level. Municipalities and counties are most severely impacted losing almost \$16,000,000.

Seniors in West Virginia are eligible for an additional refundable income tax credit for property taxes paid on the first \$10,000 of assessed value over the \$20,000 homestead exemption. To be eligible the homeowner must have federal adjusted gross income of or at 150 percent of the federal poverty limit. Federal adjusted gross does not include social security income in most cases. For 2005 the limit was \$19,245 for a family of two. If they received \$30,000 in social security then they could claim a credit with income of almost \$60,000. In FY 2005 30,000 households received credits of over \$3.8 million. The West Virginia Department of Taxation estimates that the homestead exemption reduces the local taxes for education by \$29,207,257.

Students of property taxation are in near unanimous agreement that homestead exemptions do not meet the standards mentioned above. Since they are not targeted to low-and middle income taxpayers, they are unnecessarily costly to local governments. Their greatest virtue is their simplicity. But there are more effective means of obtaining the same objective.

Caps: Property tax caps take one of two forms. Either the property tax rate is capped in the state's constitution or by legislation. The other alternative is to cap the growth rate in assessed valuations so those do not increase each year by more than an established percent. West Virginia is unique among the states in that both forms of caps are used in education finance.

In West Virginia that State Constitution and legislation have established the maximum property tax rates for each class of property which can be levied by each type of local government. For local school purposes the rate caps are:

- Class I 22.95
- Class II 45.90
- Class III & IV 91.80

In addition, the "growth factor" in the education legislation reduces the school tax rate anytime statewide property tax collections could exceed a one percent increase. This has led for the actual school rates to be rolled back from the Constitutional limits. For tax year 2005-06 these are reduced to:

- Class I 20.05
- Class II 40.10
- Class III & IV 80.20

According to the State Department of Taxation, this rollback from the maximum rates has reduced the amount of local effort by \$1,267,502 (\$19,860,452-\$18,592,950). This shortfall has increased the State's obligation by a similar amount.

Only 12 states use growth caps for property taxes. These range from 2 percent to 10 percent. The latter figure reflects the average nationwide growth in home values over the past few years. By themselves, growth caps on assessed valuations do not limit property tax growth if governments are free to raise rates. If assessed valuation caps are combined with rate caps, or if the growth cap is based on property tax yields (as is the case in West Virginia), then the growth caps are effective in reducing property taxes and the ability of school districts to raise local revenue..

But authorities on property taxation see these caps as shifting the property tax burden rather than reducing it. Since the caps usually apply only to residential, owner occupied property, the effect is to shift the burden to commercial and industrial property. (In West Virginia the rate caps apply to all property) The caps also provide indiscriminate relief for all residential owners irregardless of income. The largest dollar reductions benefit those with the most valuable property. This is inconsistent with the usual claimed benefit of caps that they protect the low income and elderly.

Split Rolls: Split rolls (also known as “classified property taxes”) refer to either using lower property tax rates for certain properties (usually residential) or to employ lower percentages for assessed valuations to which a uniform rate is applied. As noted above, West Virginia does classify property providing lower maximum tax rates for owner occupied residential (Class II) than for other types of real property. These splits are subject to the same critiques as are caps.

- They erode the local tax base restricting the ability of the local governments, including schools, to provide services.
- They put more pressure on state finances to assume greater responsibility for traditional local government functions.
- They shift the property tax burden to properties which do not qualify for the favored classification.
- They fail to target relief to those groups determined to be most in need of property tax relief.
- They provide no relief for renters.

Tax Freezes: Eleven states offer to seniors and the disabled property tax freezes. These freezes fix property taxes on the homestead at the amount levied in the year the owner turned 65 or became permanently disabled. In these states there are no recapture provisions. But when the property is no longer used by the owner or is transferred to another owner the full amount of the tax is levied for succeeding years. Renters are always excluded.

As is the case with other relief measures, tax freezes reduce the local government’s ability to finance their operations. This leads to more centralized provision or financing of the local services. Freezes are more administratively simple than some of the other property tax relief alternatives. Officials continue to evaluate the property as they do any other homesteads, but the tax is not calculated until the transfer materializes.

Freezes which do not have income thresholds for eligibility do not target the relief to the lower income home owners or to renters. The greatest dollar benefits go to the owners of the highest valued property. None of the states which use freezes include income eligibility standards.

Deferrals: Yet another form of property tax relief often available is a property tax deferral. Under this program the eligible property owner can defer the payment of all or a portion of the property tax due until they no longer use or own the premises. These deferrals usually only apply to seniors or disabled owners. When the property sells or is otherwise transferred, the property taxes due but not paid become due at the time of transfer. Some states using this alternative limit the deferral to 80- 85 percent of the tax due or limit the recapture to the last three to five years. Deferrals are usually used in conjunction with property tax freezes.

Deferrals when extended without consideration of owner's income have the same disadvantages of other approaches in that they are very costly and provide the most dollar relief to the highest valued property. Since renters are not included, lower income tenants receive no benefit.

These deferrals are costly to the local governments in the states which grant them as no state reimburses schools, counties or cities for the loss of revenue from the reduction of the property tax base.

Deferrals do not enjoy the same level of public support as do property tax freezes as the unpaid portion of the tax is recouped at the time the property transfers. These "recapture" provisions can lead to significant liabilities particularly if the owner has dwelled there for a significant time period and/or property values have raised significantly. In essence the deferred taxes are a lien on the property. These liabilities can be capitalized reducing the price buyers will offer for the property.

The justification for the recapture is straightforward. The taxes are due and to let the property owner avoid the taxes while still enjoying the benefits of local government serves as a form of "undue enrichment". Courts in states with deferrals have supported the recapture provisions on the grounds that if recapture is not present the property tax system is discriminatory against those who do pay the full amount of tax and thereby violates "equal protection" clauses in their state constitutions.

Acquisition Valuation: The most controversial form of property tax relief is acquisition valuation. Under this approach the homestead is assessed at the price it was acquired and the valuation does not change until the property again is transferred. Any increase in property taxes would be the result of increases in property tax rates.

This approach was established in California as part of the "Proposition 13" tax reform initiative which was passed by the voters in 1978. In addition to California four other states use acquisition valuation either at the state level or as a local option. The states using acquisition valuation do permit property taxes to increase if tax rates are increased.

But all limit the increases to no more than two or three percent a year. New construction and significant renovations can also be added to the acquisition value for tax purposes.

There is a Constitutional issue regarding acquisition valuation. The U.S. Supreme Court has left the issue in a limbo of inconsistency. In a West Virginia case (*Allegheny Pittsburgh Coal Co. v. County Comm'r* (1989)), the Court held that a de facto attempt by the assessor in Webster County violated the equal protection clause of the US and WV Constitutions. On the grounds that this practice treated equals unequally the Court found the practice to be flawed.

But the Court did uphold Proposition 13 in California (*Nordinger v. Hahn* (1992)) finding that the provision did serve a justified public purpose. In addition the California Constitution was revised by referendum to allow acquisition valuation. There was no such constitutional provision in the West Virginia Constitution to allow this practice. Florida followed California's lead by passing a constitutional amendment to permit the practice. It does appear that a constitutional amendment would be required in West Virginia to adopt this assessment practice.

The impact of Proposition 13 in California has received extensive investigation. The following provides a summary of the results of that research.

- Severe limitations have been placed on the school districts and other local governments who have seen their property tax bases grow at a rate significantly less than the demand for their services.
- The state government has had to significantly increase its involvement in local government activities by assuming either total or additional responsibility for funding.
- This has led to a budgetary crisis in California at the state level as local services become increasingly state responsibilities.
- What has developed is a "Welcome Stranger" policy where new arrivals are expected to pick up the costs of government services when they purchase property and find it assessed at the price they acquired it.
- This has reduced employment opportunities in California as firms at the urging of their employees have sought to avoid the "penalty" of locating there.
- Property owners are "locked in" as selling their property to acquire new property leads to property tax increases. This is particularly a problem for seniors seeking to move to more accessible accommodations.
- Huge disparities have developed between the property taxes paid on virtually identical properties. Studies on sales of properties in subdivisions where housing is essentially similar have noted differences in property tax bills of five to ten times.

Circuit Breakers: In recent decades there has been a trend for states to use property tax "circuit breakers". This idea is simple. Homeowners earning below a base income level are granted property tax relief when property taxes exceed a given percentage of their income. While 35 states now use some form of the circuit breaker, there is considerable variation in who should receive the relief and how the relief is to be calculated.

In all cases circuit breakers are a state program. The homeowner applies for the credit to the state. The state either credits the amount to the individual's state income tax liability or the state sends a check equal to the credit to the taxpayer if there is not tax liability or insufficient liability to use fully use the credit. Usually the claimant must provide evidence of residency and ownership as well as that the property tax has been paid. In some cases the application is handled at the local level with the state disbursing the payments.

Most of the circuit breaker states limit the relief to low income elderly, disabled and veterans. But there has been a move to include other low income homeowners who are "overloaded" as well. Renters are not granted circuit breaker relief in all of these states but some do. Usually it is assumed that somewhere between 20-25 percent of the rent paid reflects property taxes which the landlord passes on to the renter.

The most important question to be answered under circuit breakers is the maximum income level for eligibility. Eligibility limits now range from \$5,500 to \$200,000. A couple of circuit breaker states do not set an income ceiling. States using higher income thresholds seek to reduce the property tax burden on middle income homeowners as well as the poor. Indexing the income eligibility threshold to inflation is not usually provided which means that the value of the circuit breakers declines due to the impact of inflation.

All states using circuit breakers limit the amount of credit that can be claimed under the program. These caps range from \$250 to \$1,500. Usually there has been no indexing of these credits for inflation. There is no agreement as to the percentage of income which should be used as a "trigger". The most usual percentage is 3.5 but the reasoning behind that percentage is not clear. The Senior Citizens Tax credit in West Virginia (described above), has many of the features of a circuit breaker.

Of the surrounding states Maryland uses a complicated circuit breaker. For owner occupied homes with the owner's net worth of less than \$200,000 (not including the home), a formula is employed. Under the formula for incomes less than \$4,000 the full property tax is refunded. The threshold increases to nine percent of income above \$16,000 for a refund of the amount in excess of nine percent. The program is available to all who qualify. In addition, Maryland has an optional tax deferral program for those over 65.

States using circuit breakers note several advantages over the other approaches to property tax relief.

- Since they are targeted to selected groups defined by age, disability and income, they are much less expensive than blanket relief provisions.
- They bring the property tax into better conformity with the concept of "ability to pay" making property taxation more acceptable to the general population.
- With the state "picking up the tab" for the credits and rebates there is no erosion of the local tax base, which reduces the pressure for state assumption of local responsibilities.

The main drawback concerns the application process. Since homeowners have to apply for the credit, some who would be eligible, either out of ignorance or inertia, do not take advantage of it. Since the credits come from the state, new administrative expenses are incurred at that level. Also the state must find the money to pay for the refunds or credits. This explains why inflation indexing has not been widely accepted and the difficulty in getting income thresholds or the value of credits and credits increased.

Estimates in circuit breaker states are between 50-70 percent of those eligible actually apply. While lack of knowledge and difficulty in completing the form are two reasons for failure to file, the biggest reason is for many the refund is not worth the time and effort to file. All states with circuit breakers offer taxpayer assistance with filing.

Conclusion

Of the various methods used by the states to relieve property tax burdens including those associated with financing public education, West Virginia's use of homestead exemptions is the most expensive and least likely to produce the desired result of reducing the burden on low income homeowners. Those who study education finance and property taxation note that homestead exemptions reduce the ability of local school districts to raise revenue while giving the greatest dollar benefits to higher income individuals. Since renters are not included, almost half of the low income individuals receive no benefit at all.

Of the other options available, circuit breakers receive the most positive endorsements from both academics and the states using them. By targeting relief to low income individuals, circuit breakers focus relief on those that most are in need. Circuit breakers can also be extended to renters further increasing their beneficial impact.

Since circuit breakers take the form of either credits on state taxes or state refunds to those with little or no tax liability, the local tax base is not eroded. The state must both administer and finance the program. But the cost is less than making up shortfalls in local property tax bases by state appropriations under foundation formulas.

Investigating the possibility of further use of circuit breakers, could prove worthwhile for the West Virginia.

Appendix

State Programs for Property Tax Relief

Kentucky: Kentucky has a homestead exemption for homeowners 65 or older and those with total disabilities. The current value of the homestead exemption is \$29,400, which is adjusted every two years to reflect the increases in the consumer price index. The exemption applies to all state, local and school levies. There is no income limitation or threshold

Maryland: Maryland's "Homeowners' Property Tax Credit Program is a circuit breaker allowing for a credit or refund when the property tax exceeds a fixed percentage of the homeowners gross income. The sole criteria for eligibility are income and homeownership so the credit is available to all low income homeowners. The credit ranges based on a formula. For the first \$4,000 of combined household income there is a full property tax credit. For the next \$4,000 the threshold is 1 percent; 4.5 percent for the next \$4,000; 6.5 percent of the next \$4,000 and 9 percent for all income above \$16,000.

Ohio: Ohio grants a homestead exemption to all low income, elderly and disabled homeowners and their surviving spouses. Homeowners with earnings of \$12,900 or less receive either a 75 percent or \$5,300 exemption from their property tax whichever is less. For those with incomes up to \$25,000 up to \$1,000 or 25 percent of taxable value, whichever is less is exempt.

Pennsylvania: Property taxes in Pennsylvania are levied solely by local governments with includes cities, counties, townships and school districts. The state does not dictate assessed valuations but does place a 30 mill limit on total local taxes for some groups. Seniors over 65, their widows or widowers over 50 years of age and those permanently disabled over 18 who own a home with incomes above \$15,000. Fifty percent of social security and railroad retirement benefit payments are exempt from the calculation of income, but all other income regardless of source in included.

Virginia: Property taxes in Virginia are the responsibility of local governments including school districts. At its option a city, county or town may elect to grant relief to senior citizens and disabled homeowners. Most of the jurisdictions using this option combine it with a recapture or deferral program when the property is transferred. Usually an income ceiling of \$50,000 for legibility is imposed, but in Northern Virginia the amount may be raised by the taxing local government.