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State & Local Tax Revolt

NEW DIRECTIONS FOR THE '80s

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State and Local Tax Revolt
New Directions for the '80s

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Special Thanks to Carol Baldwin for editorial assistance
in the early stages of production.

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The research and writing of this book was
funded in part by the Shalan Foundation. Their
assistance was greatly appreciated.

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Alternative State & Local Policies
ISBN No. 0-89788-010-2

The Conference on Alternative
State & Local Policies
2009 Florida Avenue NW
Washington, DC 20009

Printed by Union Printers

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Some Pay . . . Some Don't

Evaluating property tax exemptions

by Richard D. Pomp

The more I think about it the more I realize how little time I spend on taxable property. Take this weekend, for example. I spent a fair amount of time at the tax exempt State Library doing research on tax exempt property—not so much time, I might add, that I couldn't fit in some exercise at the tax exempt YMCA, or walk through the city's tax exempt parks, or visit a friend at the tax exempt Hartford Hospital, or drop in at the tax exempt museum. Later today, I will return to my tax exempt office at the university, park in a tax exempt lot, and eat at a tax exempt cafeteria.

All this good fortune ends when I return to a taxable home at the end of the day. But some taxpayers in New York have even managed to solve that problem, at least temporarily. For \$20 the Universal Life Church will ordain you a minister through the mail. You might remember that the Church became famous during the Viet Nam War when ordination provided a divinity exemption from the draft. Now that the war is over the Church has found a new market by ordaining people who then claim that they're holding their homes as church property. For a modest \$20 investment you can earn the right to argue with the assessor over whether or not your home is indeed a church.

The variety of exemptions is enormous: exemptions are granted for federal, state and municipal property, private colleges and universities, churches, hospitals, cemeteries, scientific, literary, historical, and charitable organizations. Exemptions are thus granted for the Daughters of the American Revolution, the Lions Club, the Boy Scouts, the Hartford Medical Society, various camps, agricultural associations, athletic associations and so forth. We have a saying in the income tax area that exemptions never die—they just multiply, and it would seem the same thing is true in the property tax area. In fact, it might be said that we actually have cradle to grave tax exemptions—we are born in tax exempt hospitals

and are buried in tax exempt cemeteries.

Although the variety of exemptions is impressive, the largest proportion of tax exempt real property is found in the major cities. In the case of Hartford, the percentage of real property exempted from taxation is twice that found in the surrounding suburbs. While this is not surprising—since the cities are the administrative, cultural, medical, and educational centers for both their surrounding regions and the state—it also underscores the heart of the tax exempt problem: properties exempt from taxation provide regional and statewide benefits while the cost of such properties are disproportionately borne by the residents and businesses in the city. Indeed, as my weekend activities illustrate, I for one make ample use of tax exempt properties in Hartford but do not contribute in any direct way to the cost of these properties since I live outside the city.

The Dilemma: Draining the Tax Base

Let's be specific about what costs are imposed on the city by these tax exemptions. When land is removed from the taxable grand list because it is devoted to a tax exempt activity or purchased by a tax exempt organization, the city obviously loses the amount of property tax revenue that it previously collected. Nor does the city's cost in servicing that property necessarily decline. Tax exempt properties can consume a high level of local services in terms of fire and police protection, maintenance of the roads around the property, traffic control, sewer services, garbage collection, and so forth.

As the property tax base shrinks without a concomitant reduction in costs, the city is thrust into an untenable position. In order to make up the lost property tax revenue, either the tax rates on the remaining properties must be increased, or services must be reduced, or, more commonly, some combination of the two takes place. All this,

at the same time that inflation is driving up the cost of maintaining even the existing level of services. An increase in property tax rates, coupled with a decline in the real level of services, only encourages individuals and businesses to leave the city and landlords to abandon marginal buildings.

As businesses and jobs leave the city, as buildings get abandoned, and as the more affluent residents migrate to the suburbs, the property tax base is eroded even further. Since the state has limited local governments to raising revenue only through the property tax, further erosion of this base touches off yet another cycle of raising the mill rate or cutting services.

This cycle has another and perhaps even more serious dimension to it. Because the more affluent and mobile individuals have migrated to the suburbs, the city is left with a disproportionate share of the state's poor and elderly. The cost of tax exempts thus falls on those least able to bear the additional costs, exacerbating the already regressive nature of the existing state and local tax system. Tax exempt property therefore raises a fundamental question of taxpayer equity: Is it fair to impose all of the burden of the state enacted real property exemption on the residents and businesses of the city, when the benefits and services generated by these properties (not to mention jobs provided for commuters), accrue to those living outside of the city?

Some numbers may help illustrate the problem. In Hartford, for example, the grand list actually declined from '75 to '76 while the value of tax exempt property actually increased. The tax revenue lost between '71 and '76 due to tax exempts (not including municipal property) has been estimated at \$124 million. This is \$124 million the city otherwise would have had, and which the city had to make up through an increase in property tax rates and a curtailment in services.

Approaching the Problem: Some Considerations

Obviously, any move involving that amount of revenue requires careful deliberation. In thinking about the subject of tax exempts, it is useful to break the problem down into three parts:

- whether the existing exemptions ought to be continued and if so, for which activities;
- which is the appropriate level of government to bear the costs of the exemptions; and
- what are alternative ways of subsidizing the activities of organizations that we wish to encourage, and generally what options are available to the state.

In approaching the first consideration, we have to keep in mind that once an exemption is provided by the law, taxpayers will restructure their transactions to bring themselves within the blessed exempt category. This is most clearly illustrat-

ed by the following example. A local Hartford church purchased 121 acres of vacant land in New Britain for \$23,500. One body was buried there and the land was exempted as a cemetery. In 1966, when the land had appreciated to \$607,000, the body was removed and the cemetery sold. Experiences of this sort are not unique to Connecticut; every state has its own parade of horrors. And we can only speculate on how many examples of abuse never surface.

Cleaning up the gray areas in the statute is of course desirable, but what is really necessary is a wholesale evaluation of the scope of existing exemptions. When tax rates were low, when the cities were thriving, we could live with broad, generous, wide reaching exemptions. We cannot today. If I were to reexamine the statute, I would grant an exemption only if the activity or service is one which the government would have to perform if a private entity did not, and only if the subsidy is required to provide the service at a price which all members of the public who ought to have access to the service are able to pay.

Thus, a strong candidate for exemption under my criterion would be the Red Cross, Salvation Army, a hospital that treated the indigent, or a library. A strong candidate for denial of an exemption might be a medical, dental, or bar association.

Assuming that *some* exemptions are in order, the next question is to decide which level of government should finance the costs of these exemptions. I've already suggested that many exempt properties provide general and diffused benefits to areas beyond their host jurisdiction. This fact is quite clearly seen in the case of state buildings such as the Capitol. This same lack of identity between the host jurisdiction and the tax exempt's constituency is true, at least to some degree, in other cases. A recent study found that less than half the patients treated in tax exempt hospitals in Bridgeport, Hartford, New Haven and New London actually lived in the host jurisdiction. The results were even more pronounced in the case of colleges and universities located in these cities.

Perhaps in the past there was more of an overlap between the jurisdiction in which the property was located and the jurisdiction in which the beneficiaries lived, but the growth of the suburbs and the increased mobility of individuals have produced a situation where many of the benefits and services generated by tax exempts are now provided to residents of other jurisdictions. In light of that situation, it's clear that the compensation for revenue loss should be provided by the *larger* jurisdiction benefitting from the exemptions.

Finally, assuming again that some special treatment is to be provided to certain organizations, what form should this take? The present treat-

ment, an exemption from property taxes, is probably one of the least rational methods. Consider, for example, two organizations, X and Y. X is financially struggling and can afford only to rent office space; Y is well established, well endowed, and is known for its generous staff salaries and opulent headquarters located on highly desirable and expansive prime real estate. Has the state consciously chosen to ignore the struggling organization but grant benefits to the less needy organization? Has the state consciously chosen to increase its benefits on the basis of how much land and buildings Y owns?

To put it another way, if the state were to grant cash subsidies to organizations that are presently exempt, would it adopt a program that gave nothing to organizations so poor that they cannot afford to own real estate and instead, gave money on the basis of how much real property was owned? That is the effect of the existing law except that it is the *local* jurisdictions that are granting the cash subsidies by not collecting the property tax they otherwise would.

Because of these irrationalities, my own preference would be to replace the property tax exemptions with an explicit cash subsidy. (The exemption could be continued for religious organizations, since a cash subsidy would be unconstitutional.) If a system of cash grants were adopted, I have no doubts that the state would narrow the existing law, so as to channel money to only the neediest of qualifying organizations.

What's To Be Done: Some Options

I have no illusions about a wholesale change in the law and the following recommendations all assume that the general scheme of property tax exemptions will continue. Nonetheless, understanding the defects in the current approach is useful in identifying areas where a better balance can be reached among the interests of the tax exempts, the cities, and the state. There are a number of alternatives available, among them:

- Requiring the permission of the local jurisdiction before any taxable property can be removed from the grand list. This approach places the decision making power at the level of government which bears the cost of the exemption, and allows the localities to decide whether the *benefits* of the exemption really justify that *cost*.

- Phasing in the exemption when taxable property is being removed from the grand list. This option provides a cushion so that the jurisdiction does not suffer an abrupt decline in revenue in the year of purchase.

- Setting a time period beyond which the exemption will be phased out. A time limitation would enable new organizations to get started without the burden of the property tax but at the same time would assure that the host jurisdiction

is not burdened with a perpetual exemption. A sufficient time period will allow the organization to adequately plan for the eventual phasing out of the exemption.

- Setting a limit on the number of acres qualifying for the exemption or a dollar limit on the amount of property which can be exempt. These approaches attempt to balance the interests of the tax exempts against the revenue loss incurred by the host jurisdiction. Once some reasonable level of property ownership has been exempted, further expansion should not be at the expense of the local government. Meanwhile, an organization which owns property exceeding the ceiling indicates a certain level of wealth or ability to pay that does not justify any further exemption.

- Imposing a user charge. Although it may be deemed undesirable to subject tax exempt properties to the normal property tax, this option recognizes that these properties consume local services and at a minimum, should contribute something to the costs of local government.

A simple means of implementing a user charge approach is to estimate the percentage of the jurisdiction's total budget that is devoted to supplying services such as fire and police protection, traffic control, garbage collection, sewer services, and apply that percentage of the mill rate to the value of the tax exempt property. For instance, if 35% of the budget were estimated as being devoted to the provision of these services, and if the mill rate were 60, then the assessed value of tax exempts would be subject to a user charge of 21 mills (.35 x 60).

While it is obvious that many of the current tax exempts are fully capable financially of meeting the costs of user charges, it can be argued that others are not. To offset that problem, it would be possible to institute a system of user charge circuit breakers, which would provide relief based on need.

- Requiring state payments to jurisdictions containing tax exempts. This option recognizes that it is unfair for the host jurisdictions to bear the entire cost attributable the presence of tax exempts. Recently adopted in Connecticut, it extends the state's PILOT (Payments in Lieu of Taxes) program to *non*-state owned property, on the theory that the exemption from property tax, which is granted by the state, helps to implement state objectives and goals.

In order to channel funds where it is needed most, payments could be made only to jurisdictions having more than the statewide average of tax exempt property.

"Some Pay... Some Don't: Evaluating Property Tax Exemptions" is reprinted by permission from the September, 1978 issue of *People and Taxes*, Public Citizen Tax Reform Research Group.