CHAPTER 18

PROPERTY TAXES

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"Should property taxes be reduced?"

No tax is popular, but national surveys indicate the property tax is particularly unpopular. Ironically, there is much to be said in its favor.

A good tax apparatus will generate a stable cash flow for government, have little impact on taxpayers' economic decisions and be equitable in the sense that people in similar situations pay similar amounts. Relative to other possibilities, an annual tax on property values fits this description reasonably well.

There's more. The property tax is relatively easy to administer, and compliance costs are remarkably low. Perhaps most important of all, most experts rate it high on the "fairness" scale. Here's why:

First, per capita differences in county tax bases tend to be larger under either an income tax or a consumption tax. In plain English, this means the property tax is relatively good at smoothing out the differences between "rich" counties and "poor" counties.

Second, to the extent it is a tax on housing consumption, it generally falls evenly across income classes. That is, it tends to be a proportionate tax on housing consumption. Better yet, as a tax on investment property it tends to be disproportionately borne by high-income individuals. A tax that is partly proportionate and partly progressive seems fairer than other possible sources of county revenue which tend to be regressive.

Third, because the property tax is highly visible, taxpayers are especially likely to hold government accountable for sensible use of the money. Governments tend to function best when taxpayers are vigilant.

Fourth, property taxes satisfy the "benefit principle." That is, the correlation between taxes paid and benefit received tends to be relatively high. Local services, such as police, fire protection and roads are basically site-oriented—they benefit property owners by protecting or increasing their property values. The importance of this benefit principle cannot be overstated.

Helpful assumptions. Not convinced? OK, let's approach your question from a completely different direction. To do so, we must make several assumptions. The first is that the total amount of all taxes—on income, sales, property, gas, etc.—currently collected in Hawaii by state and county governments is neither too high nor too low. The second: state and county governments have been combined into one giant Hawaii Government that receives all taxes and provides all government services. This second assumption will help us deal separately with the fact that public schools in Hawaii are not funded through the property tax.

A good state-wide tax system will include more than just one source of revenue. Multiple sources make possible a stable flow of revenue with lower rates, better compliance and a relatively level playing field. As a result, much can be said in support of having Hawaii Government tax more than just income, more than just sales and more than just property. (Remember, the level of total taxes is not yet an issue here.)

Given these assumptions, if property taxes were to be eliminated, the revenue loss would have to be made up elsewhere. This generally would mean that income and/or excise taxes of renters (among others) would have to go up so that homeowners' and investors' property taxes could come down. Does that sound fair?

It has been estimated that a greater percentage of total property taxes—as compared to income and excise taxes—is borne by nonresidents. Calculation of the percentage of any particular tax ultimately borne by nonresidents ("exported") is an inexact process. Nevertheless, three separate studies have pegged the export rate for the property tax within a few points of 40 percent. Other studies have calculated an approximately 30 percent export rate for the excise tax. The rate for the income tax has been put at less than 20 percent. If these studies are accurate, a shift in reliance from property taxes to income or excise taxes would result in a reduction in the amount of taxes exported. Also, income and excise taxes can be avoided by foreign investors (legally and illegally) more easily than property taxes. Do you really want to shift taxes from nonresidents to residents and make it easier for foreign investors to avoid paying Hawaii taxes?

Inflated property values. Perhaps by now you are thinking that the property tax is not all bad, but you wonder if it makes sense to base the property tax on market values when those amounts are so greatly inflated.

The property taxes you pay are based on two factors: assessed value and tax rate. It makes no sense to complain about property taxes solely on the basis of high assessed values. For example, if some mainland state with low property values were to increase everyone's assessed value tenfold, but simultaneously reduce everyone's tax rate by the same factor of ten, the taxes paid by each property owner in that state would remain unchanged. Would their taxes now be oppressive because of the high assessed values of their properties? Obviously not.

Some residents in high-priced areas of Hawaii complain that the market values of their homes were "puffed up" disproportionately by purchases (primarily by foreign investors) during the late 1980s and early 1990s. Arguing that most of this run-up in value was artificial and of no immediate benefit to them, they contend that the assessed value of their homes should never go up by more than some fixed, islandwide rate. Examples of older people being forced to sell their homes in order to pay property taxes sometimes are cited. (The counties provide extra exemptions based on age, but these are of limited benefit to homeowners in particularly high-value areas.)

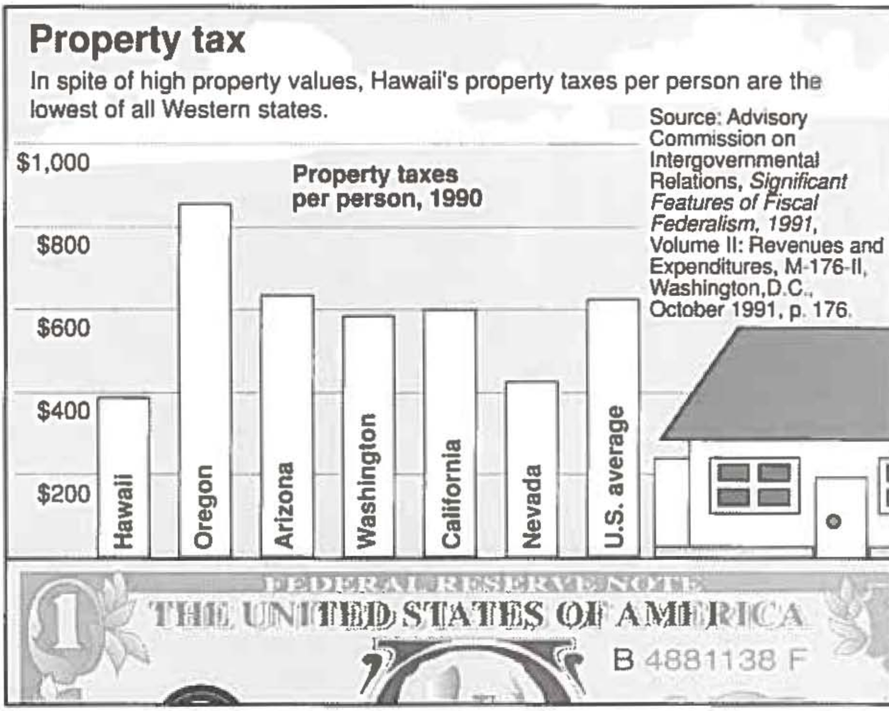
California's "Proposition 13" approach of limiting annual increases in assessed value to an artificially low percentage (until the property is sold, at which time the assessed value is set at market value) benefits existing homeowners, but increases the burden of other taxpayers generally and future home buyers in particular. A Hawaii homeowners group has promoted a Hawaii version. Though legal, this approach inevitably would lead to unfair distinctions and should not be pursued. One critic of Proposition 13 has publicly identified a $2.1 million beach-front property in Malibu with an assessed value equal to that of his own recently purchased $170,000 home in Baldwin Hills. Does that sound fair?

Targeted relief. The counties easily could develop additional relief mechanisms for targeted homeowners who can no longer afford to pay property taxes. Such relief could take any number of forms, the most logical of which would be a "circuit breaker" that limits property tax liability to a maximum percentage of a homeowner's income. A growing number of jurisdictions on the Mainland take a different approach. They give homeowners the option of letting unpaid taxes accumulate, at interest, until the owner's death. In effect, the government thereby gets into the home equity loan business, using money provided by other taxpayers. The point is that relief easily can be targeted to deserving individuals. The fact that some property owners need relief is a separate issue from the overall level of property taxes.

Interesting comparisons. You might find it interesting to compare the level of property taxes in Hawaii to those of other states. In 1990, per-capita property taxes were $384 in Hawaii. This was quite low compared to the U.S. average of $626. Similarly, property taxes per $1,000 of personal income were quite low in Hawaii ($20.72) compared to the U.S. average ($35.62).

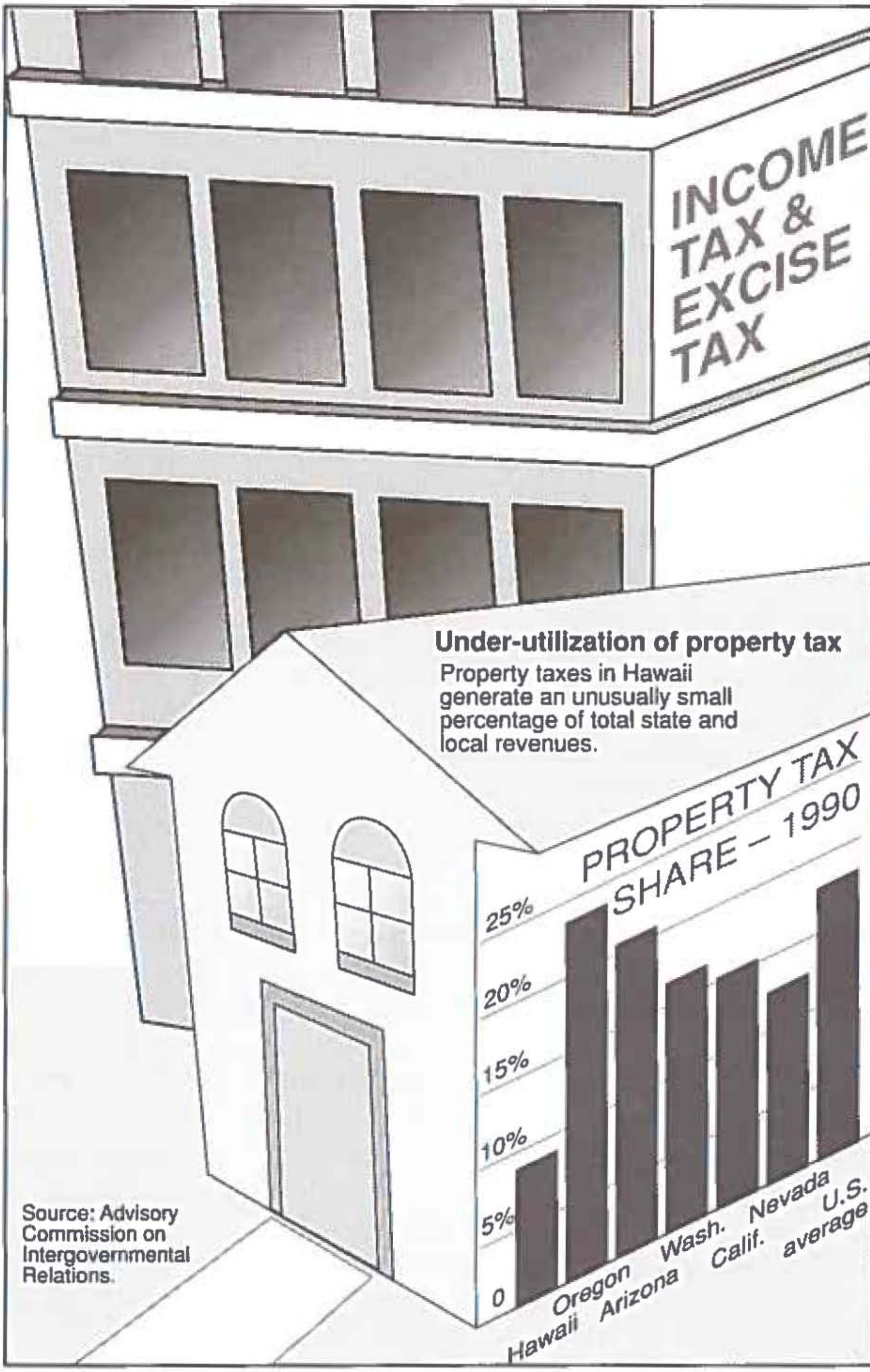
A Coldwell Banker survey in January 1990 compared prices and property taxes on a "standard executive home" (2,200 square feet with four bedrooms, two-and-one-half baths, family room and two-car garage in a neighborhood typical for corporate middle management) across the nation. The prices varied from $81,666 in Corpus Christi, Texas, to $916,666 in Beverly Hills, California. The price in Honolulu was $438,333. The average of the property taxes actually assessed that year on the Honolulu homes included in the survey was $1,116, far below the national average of $2,507. The Honolulu tax figure was below those of numerous "low cost" cities, including Corpus Christi!

In early 1992, *Money* magazine published the results of a city-by-city property-tax study based on 1991 data. It compared property taxes on a median-value house, as reported in the 1990 Census, in the area



of each locale where moderately affluent homeowners (median household income in 1991 of $69,275) were most apt to live. Amounts ranged from zero in a few Louisiana parishes to almost $6,000 in several New Jersey counties. The property tax figure for Honolulu was $830. Specific areas included Salt Lake City ($800), Dallas ($1,250), Miami ($1,300), Sacramento ($1,623), Milwaukee ($2,000), Los Angeles ($2,830), and San Francisco ($3,736). The $830 Honolulu figure was one of the lowest in the study.

No logical connection. Many people argue that everybody's property taxes should be low in Hawaii since they are not used to fund public schools as they often are on the Mainland. This mentality assumes some sort of logical or even necessary connection between property taxes and the financing of public schools. Ironically, many experts question whether the property tax is the most appropriate device for financing public education. Since the mid-1970s the trend on the Mainland has been to substitute state revenues for property taxes to fund public education. Besides, it would make sense to tax wealth


INCOME TAX & EXCISE TAX
Under-utilization of property tax
Property taxes in Hawaii generate an unusually small percentage of total state and local revenues.
PROPERTY TAX SHARE – 1990
25%
20%
15%
10%
5%
0
Hawaii
Oregon
Arizona
Wash.
Calif.
Nevada
U.S. average
Source: Advisory Commission on Intergovernmental Relations.

(along with income and consumption) even if there were no public schools. The counties have required regular cash subsidies from the State in recent years and that money came out of income and excise tax revenues. If property taxes were higher, the State would be in a position to cut income and/or excise taxes.

One can easily argue that Hawaii relies too much on income and excise taxes and not enough on property taxes. In 1990, property taxes contributed only 8.5 percent of total state and county revenue in Hawaii. This was far below the U.S. average of 18.3 percent. Some people don't think it's fair that nonproperty owners have to make up for foregone revenue lost to relatively wealthy property owners.

I have suggested that property taxes are not inherently unfair and that they have been underutilized in Hawaii. Does that mean property taxes should be raised?

The overall level of taxes in Hawaii is extraordinarily high. The public sector is extraordinarily big. Government in Hawaii cannot continue to consume ever-increasing pieces of the economic pie without having it result in smaller and smaller pies. The counties may be underfinanced, and property taxes truly are underutilized, but that does not mean the overall level of taxes in Hawaii should be raised. The degree to which the property tax is underutilized arguably is less than the degree to which the income and excise taxes are overutilized. Keep that in mind as the State tries to get the counties to increase property taxes.

If constituents are alert, they will not argue that property should not be taxed, or even that it should not be taxed more heavily. And they will not be confused by the fact that public education in Hawaii is not financed with property taxes. Instead, they will demand that income and/or excise taxes be reduced by the amount of any property tax increase.

The State is like the magician who wants you to watch the hand labeled "counties." Keep an eye on the other hand, the one labeled "state." It's the one that has your wallet.

"IS IT FIT? COMFY?.. NOW LET ME TELL YOU WHY WE'RE GIVING YOU THE HELMET..."