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City of Alexandria, Virginia

MEMORANDUM

DATE: FEBRUARY 25, 2008

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT BUDGET MEMO # 8 : IMPACT OF PROPOSED HOMESTEAD EXEMPTION CONSTITUTIONAL AMENDMENT

As requested by Councilman Wilson, attached you will find the analysis of the Homestead Exemption issue that City staff prepared for the Ad Hoc Commercial Transportation Tax Study Committee. Most of this information was initially prepared for Mayor Euille's presentation at VML this past fall. Also attached is an article on the same subject by John Knapp at the Weldon Cooper Center for Public Service at the University of Virginia.

Attachments

Proposed Homestead Exemption

An analysis by City staff was done when this idea was first proposed showed that a 20% homestead exemption, such as the one proposed by Governor Kaine and now working its way through the General Assembly, by itself could reduce the City's revenues by approximately $28.6 million, based on CY 2006 assessments. The decrease in revenues would have to be made up by expenditure cuts, increases in other taxes and fees, or an offsetting increase to the real property tax rate.

The chart below shows the estimated decrease in revenues by category, and the increase in the real property tax rate should the real property tax rate be increased to make up the revenue deficiency. It is apparent from the chart that about 38% of the tax decrease would go to the owner-occupiers of detached homes. 73% of the tax decrease would go to the owners of detached or attached single family homes. A 20% homestead exemption offset would cost the government the equivalent of a 9.1 cents in the real property tax rate for all property owners.

Tax Revenue

	Share of Homeowners Subject to Homestead Exemption, by Category	Current Real Property Tax Revenue	Revenue after 20% Homestead Exemption	Difference	Equivalent Tax Rate Impact
Detached	95.0%	$56,805,162	$46,012,181	$10,792,981	
Attached	90.0%	$55,560,343	$45,559,482	$10,000,862	
Condo	75.0%	$52,026,751	$44,222,738	$7,804,013	
Total	-	$278,603,698	$250,005,843	$28,597,855	9.1

The chart below shows the expected tax bill reduction (using the 2007 assessment data) for the average owner/occupier of single family homes and condos.

	Tax Rate	All	Single Family	Condo
Average Property Value		$509,593	$ 660,866	$ 341,008
Average taxed property value under homestead		$407,674	$ 528,693	$ 272,806
Average tax bill-current	0.83	$ 4,230	$ 5,485	$ 2,830
Average Tax bill – Homestead	0.83	$ 3,384	$ 4,388	$ 2,264
Average Tax bill – Homestead	0.921	$ 3,756	$ 4,871	$ 2,513
Total Net Reduction		$ 474	$ 614	$ 317
% Net Reduction		11.2%	11.2%	11.2%

If the homestead exemption were funded out of a higher real property tax rate, the average bill for owner/occupiers could be expected to decrease by a net amount of approximately 11.2%. The tax decrease dollar amount under a straight 20% exemption would be larger for the owner/occupiers of more expensive single family dwellings than for the owner/occupiers of condos. Also, commercial properties (including apartments) would not be eligible for the homestead exemption and would pay the tax rate increase of 9.1 cents. It is also possible that landlords might pass the cost of increases to the real property tax rate on to their tenants, increasing rents throughout the City.

Overall, we estimate that from a tax equity standpoint, the homestead exemption would transfer the tax burden of the City's upper income residents to businesses and to the City's lower and middle income residents. While there are ways to structure the homestead exemption to make it more progressive (such as a 20% exemption not-to-exceed $50,000), based on the proposed constitutional amendment and the enabling legislation (sample attached) the impact of shifting the tax burden to the commercial sector does not have clear property tax-based remedies.

Attachment: HB 1118 (as of 1-22-08)

Data Source: City of Alexandria Office of Management and Budget

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2008 SESSION

INTRODUCED

082873802

HOUSE BILL NO. 1118

Offered January 9, 2008

Prefiled January 9, 2008

A BILL to amend the Code of Virginia by adding in Chapter 32 of Title 58.1 an article numbered 2.01, consisting of a section numbered 58.1-3218.1, relating to exemptions from and deferrals of local real estate taxes for certain residential or farm property designed for continuous habitation.

Patrons—Miller, P.J., Alexander, Bouchard, Ebbin, Eisenberg, Howell, A.T., Johnson, Jones, D.C., Mathieson, McClellan, Melvin, Morrissey, Plum, Scott, J.M., Spruill and Vanderhye

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Referred to Committee on Privileges and Elections

Be it enacted by the General Assembly of Virginia:

1. That the Code of Virginia is amended by adding in Chapter 32 of Title 58.1 an article numbered 2:01, consisting of a section numbered 58.1-3218.1 as follows:

Article 2.01.

Exemptions and Deferrals of Real Estate Tax for Residential or Farm Property Designed for Continuous Habitation.

§ 58.1-3218.1. Exemptions from and deferrals of real estate taxes; certain residential or farm property.

A. For purposes of Article X, Section 6 (k) of the Constitution of Virginia, and as used in this section, the term "value" means the assessed value or the assessment for local property taxation purposes.

B. Pursuant to Article X, Section 6 (k) of the Constitution of Virginia, for tax years beginning on or after January 1, 2009, the governing body of each county, city, or town may, by ordinance, (i) exempt or partially exempt from real property taxation, (ii) provide for the deferral of real property taxes, or (iii) provide for a combination program of exemptions from and deferrals of taxation of real property of up to 20 percent of the value of real property that is (a) residential or farm property designed for continuous habitation and (b) occupied as of the tax day as the primary dwelling of the owner or owners, who shall all be individuals. For purposes of this section, real property shall include any "manufactured home" as defined in § 36-85.3 and assessed pursuant to § 58.1-3522.

As provided in Article X, Section 6 (k) of the Constitution of Virginia and as otherwise authorized by law, any restrictions, conditions, or classifications of the tax relief program described under this section shall be provided by the local ordinance, including provisions to verify eligibility.

C. The governing body of the county, city, or town shall provide annual written notice to the general public of any local real estate tax exemption or deferral program established in the jurisdiction pursuant to this section. Such notice shall be enclosed with each real estate assessment notice or any other appropriate mailing or notice as determined by the local governing body.

D. In the event of a deferral of real estate taxes granted by ordinance pursuant to this section, the accumulated amount of taxes deferred shall be paid to the applicable county, city, or town by the vendor upon the sale of the dwelling, or from the estate of the decedent within one year after the death of the last owner thereof who qualifies for tax deferral under the local ordinance. Such deferred real estate taxes shall constitute a lien upon the said real property as if it had been assessed without regard to the deferral permitted under the local ordinance. Any such lien shall, to the extent that it exceeds in the aggregate 10 percent of the price for which such real property may be sold, be inferior to all other liens of record.

2. That the provisions of this act shall not become effective unless an amendment to the Constitution of Virginia, providing that the General Assembly may allow the governing body of any county, city, or town to exempt or partially exempt from real property taxation or provide for the deferral of real property taxes, within such restrictions and upon such conditions as may be prescribed by the governing body by ordinance, of up to 20 percent of the value of residential or farm property that is designed for continuous habitation and is occupied as the primary dwelling of the individual owners, is affirmed by a majority of those voting at the election and upon such question in November 2008.

INTRODUCED

HB1118

1/22/08 8:55

Vol. 84 No. 1 January 2008

The Virginia
NEWS LETTER

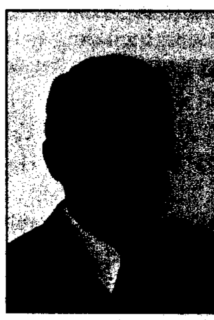
Problems with the Proposed Homestead Constitutional Amendment

By John L. Knapp

In 2007, both houses of the General Assembly overwhelmingly approved Senate Joint Resolution 354, providing for a constitutional amendment that would empower local governments to provide tax relief for owner-occupied single-family housing.[1] The homestead amendment, as it is popularly known, contains the following language:

> The General Assembly may by general law allow the governing body of any county, city, or town to exempt or partially exempt from real property taxation or provide for the deferral of real property taxes, within such restrictions and upon such conditions as may be prescribed by the governing body by ordinance, of up to twenty percent of the value of residential or farm property that is designed for continuous habitation and is occupied as the primary dwelling of the individual owners.

To amend the constitution it will be necessary for the 2008 General Assembly, which will be the first regular session after the last general election, to again pass the proposed



John L. Knapp

amendment, with no change in wording, in both houses. Passage appears very likely. In that case, the amendment will be offered to voters on the November 2008 ballot.

Constitutional provision for tax relief was an issue in the 2005 gubernatorial contest. The Democratic nominee, Timothy M. Kaine, endorsed a proposal similar to SJR 354. The Republican nominee, Jerry W. Kilgore, proposed a cap of 5 percent on annual increases of assessed value of residential owner-occupied properties.

At the time of the election, housing values were rising rapidly, and they continued to do so until 2007. According to the House Price Index (HPI) for Virginia, the annual rate of increase peaked at a blistering 21.2 percent in the second quarter of 2005.[2] For the most recent period available, the third quarter of 2007, the annual rate was 2.9 percent, with prospects for very low growth

1 http://leg1.state.va.us/cgi-bin/legp504.exe?ses=071&typ=bil&val=sj354 (12/28/07)

2 Office of Federal Housing Enterprise Oversight (OFHEO) House Price Index http://www.ofheo.gov/hpi.aspx?Nav=275 (1/8/08)

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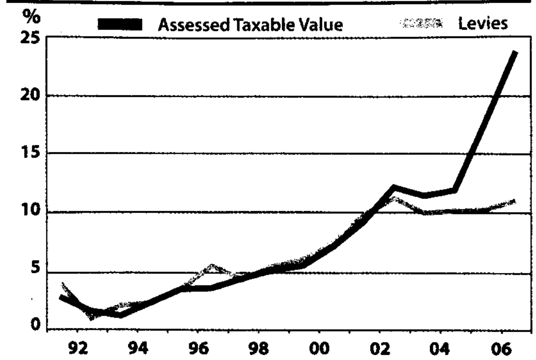
or decline in the next eighteen months. The inflation in house values was not uniform throughout the state. Relative appreciation was greatest in the Northern Virginia, Hampton Roads, and Charlottesville metropolitan areas. The HPI understates the earlier growth and the subsequent decline in the rate of growth because of its omission of transactions financed with sub-prime mortgages and with mortgages of more than $417,000, segments of the market that ideally should be included. Nevertheless, the HPI is the only measure available for states and all metropolitan areas.[3]

Appreciation of house values does not automatically result in higher tax collections from the real property tax.

Appreciation of house values does not automatically result in higher tax collections from the real property tax. Local governing bodies set the tax rate each year. When assessed values rise due to increases in property values, local governments can adjust their tax rate so that tax collections do not rise. However, local governments usually take advantage of part of the increase in assessed values by lowering the tax rate, but using a reduced rate that still raises more revenue. This explains why in recent years levies grew at a substantial rate, about 10 percent annually after 2000, while assessed values, including new properties, grew even faster (**Figure 1**).

The increase in assessed values was much greater for single-family residential property than for other types (**Table 1**). Most of the gain in single-family residential values was due to higher prices. Only about 10 percent of the increase was attributable to new construction.[4]

Figure 1: Annual Change in Virginia Assessed Values and Levies,1991 - 2006



Source: Annual reports of the Virginia Department of Taxation

The disparity in growth rates for different types of property is not unusual. Historical data for the U.S. since 1994 show that prices for different types of property have not moved in concert. Over the full period from 1994 to 2006 the price index for single-family residences grew slower than those for office buildings, apartments, and industrial property and faster than the index for retail property.[5]

Analysis of the Proposal's Effects

How would the proposed amendment impact local governments? The answer is not straightforward because there are many possibilities, ranging from no impact if no local governing body would adopt a homestead exemption to a major impact if all local governments were to adopt the maximum exemption. The most probable outcome is that many local governments would provide an exemption, although not necessarily the full 20 percent. This would not occur immediately but would be phased in over a number of years as governing bodies acceded to homeowner pressure and emulated tax relief provided by neighboring jurisdictions.

Table 1: Percentage Increase in Virginia Total Taxable Assessed Value by Type of Property, 2000 to 2006

Type of Property	Percentage Increase
[illegible]	[illegible]
Multifamily residential, owner and renter-occupied	92.4
[illegible]	68.2
Agriculture (use-value where applicable)	61.1
[illegible]	123.2

Source: Unpublished data from the Virginia Department of Taxation

3 The S&P/Case Shiller Index, that is available for the nation and major metropolitan areas, shows a recent decline in national prices versus the small increase shown by the HPI. See Andrew Leventis, "A Note on the Differences Between the OFHEO and S&P/Case-Shiller House Price Indexes," Office of Federal Housing Enterprise Oversight (July 25, 2007) www.ofheo.gov/media/research/notediff2.pdf (1/16/08).

4 From 2000 to 2006 single-family residential assessed values grew by $404.1 billion while the value of private new residential construction of single-family units totaled $39.5 billion. Sources: Virginia Department of Taxation unpublished data and Bureau of the Census data on housing units authorized by building permits. http://www.census.gov/const/www/C40/table2.html (1/16/08).

5 This observation is based on Moodys/REAL Commercial Property Price Index (CPPI) whose methodology was developed at MIT and the aforementioned OFHEO HPI for the U.S. See: MIT Center for Real Estate http://web.mit.edu/cre/research/credl/rca.html (1/18/08)

Table 2: Revenue Impact of the Proposed Homestead Amendment if All Cities and Counties Adopt the 20 percent Maximum Exemption, 2006 (Millions of Dollars)

Item	Single-Family Owner-Occupied Housing	All Other	Total
Actual			
Assessed taxable value	$582,552.0	$316,758.0	$899,310.0
Tax @ $0.85 per $100	$4,943.0	$2,694.0	$7,637.0
Proposed			
Alternative 1			
Assessed taxable value if single-family property assessed at 80% and all other at 100%	$466,041.6	$316,758.0	$782,799.6
Tax @ $0.85 per $100	$3,954.4	[illegible]	[illegible]
Change from actual total tax			
Amount	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
Alternative 2			
[illegible]	[illegible]	[illegible]	[illegible]
Change from actual total tax			
Amount	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]

Sources: Virginia Department of Taxation unpublished data on city and county assessed values by class of property and published data on local levies in the Fiscal Year 2007 Annual Report, Table 5.2. Bureau of the Census, American Housing Survey for 2005 http://www. cnsus.gov/hhes/www/housing/ahs/ahs/ahs05/tab1a1.html (1/15/08).

NOTE: For this calculation the author assumed the share of single-family property occupied by owners is 86.2 percent, the national proportion reported by the Census Bureau for 2005. Unrounded tax rates were used in the calculations.

The type of exemption that would be adopted by individual localities is unknowable.

The type of exemption that would be adopted by individual localities is unknowable. Some localities might provide a blanket percentage exemption for all homeowners; should the state enabling statute permit them, others might impose restrictions related to the length of time of ownership, age of owner, and owner income and net worth. Once a local government provided an exemption, it is unlikely the governing body would rescind it in a later year since homeowners, who are well represented among voters, would assume a sense of entitlement about the assessment relief. Furthermore, it is possible, but not likely, that local governments would adopt the deferral provision. Under existing state law, local governments can offer deferral but none have done so.[6] Apparently, deferral is not popular with voters because it does not reduce taxes—it merely postpones them.

Because of the many plausible assumptions that can be made about local government behavior if the amendment is approved, it is not possible to estimate their foregone revenue unless one assumes that all local governments adopt the 20 percent maximum exemption. Even though that outcome is unlikely, an estimate based on that premise is instructive. **Table 2** shows the statewide impact of the proposed amendment based on 2006 data, the most recent available. Owners of single-family, owner-occupied, residential properties paid $4,943 million in taxes, and owners of all other real property—residential rental property, business property, commercial property, and farm property—paid $2,694 million in taxes. Under the homestead amendment, all localities could exempt up to 20 percent of the assessed value of the aforementioned single-family property. If this were done and there were no compensating increase in the tax rate to replace the foregone revenue (alternative 1 in the table), the homeowners' tax bill would be $3,954.4 million, a $988.6 million decrease. The tax bill for other properties would remain the same. The decrease in revenue for homeowner property would result in an overall reduction in revenue of 12.9 percent, a hefty decrease.

If the local governing bodies wanted to restore the lost revenue, they could do so by increasing the tax rate so that the total revenue

[6] John L. Knapp, William M. Shobe, and Stephen C. Kulp, *Virginia Local Tax Rates, 2007* (Charlottesville: Weldon Cooper Center for Public Service, University of Virginia, 2007), pp. 5-6.

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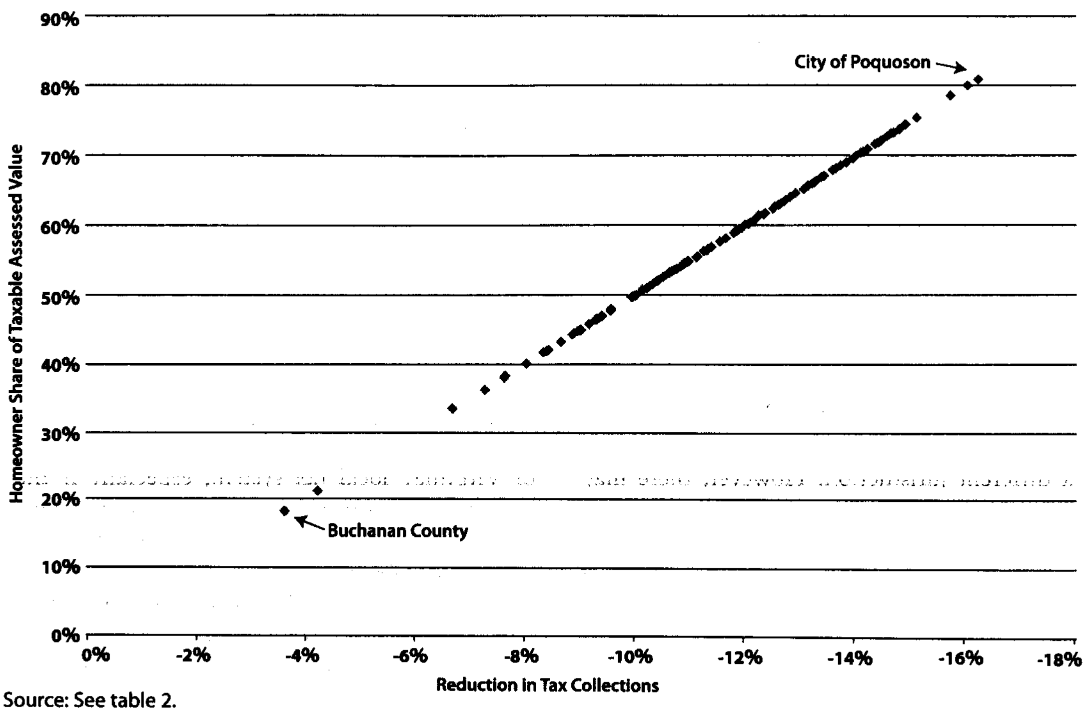
Local governments would not be evenly affected

Figure 2: Homeowner Share of Assessed Value and Reduction in revenue if Exemption Were 20 Percent in All Cities and Counties, 2006



Source: See table 2.

would be the same as before the homestead exemption (alternative 2 in the table). This could be achieved by increasing the rate from $0.85 per $100 of assessed value to $0.97. Homeowners then would have a tax bill of $4,552.5 million, an amount 7.9 percent less than before the exemption. All other property would have a tax liability of $3,084.5 million, an amount 14.5 percent more than before the exemption. Homeowners would now pay 59.6 percent of total real property taxes, *down* from 64.7 percent before the homestead exemption. All other property would pay 40.4 percent of the tax bill, *up* from 35.3 percent before the exemption

Local governments would not be evenly affected by the homestead amendment if it were fully implemented. For localities with a large portion of their taxable assessed value in homeowner property, the percentage revenue loss would be much greater than for those with a small proportion (**Figure 2**). The locality with the highest ratio of homeowner property, the city of Poquoson with 81 percent, would experience a 16.2 percent reduction in total revenue. In contrast, the locality with the lowest ratio of homeowner property, mountainous Buchanan County, where homeowners accounted for only 18 percent of assessed value, would experience a 3.7 percent decline.

Related Concerns

Aside from the possible effects of the homestead exemption, localities face a difficult situation in the next few years because of the poor housing market. The localities that will be under the greatest pressure in tax years 2008 and 2009 will be the 31 cities and 26 counties that reassess annually or biennially.[7] The assessed values on their books represent valuations made toward the end of the housing boom. This group includes all of the major cities and all of the large, urban counties. The localities with less frequent assessment cycles will not be as stressed even if they are scheduled for reassessment in 2008 or 2009 because in most cases, residential property values will be higher than the last reassessment, even if market values have fallen in recent years

As part of the 2007 Transportation Act the General Assembly empowered cities and counties in the Northern Virginia Transportation Authority (NVTA) and the Hampton Roads Transportation Authority (HRTA) to impose a surtax on commercial and industrial property not to exceed $0.25 per $100 for the NVTA and $0.10 for the HRTA provided that the revenue is used for transportation purposes benefiting the locality imposing the tax.[8] The city of Alexandria

[7] Knapp, Shobe, and Kulp, *Virginia Local Tax Rates, 2007*, pp. 10-12.

[8] House Bill 3202, 2007 Session. See Section 58.1-3221.2 http://leg1.state.va.us/cgi-bin/legp504.

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and the counties of Arlington and Fairfax have adopted ordinances needed if the extra tax is imposed, but no rate has been set yet.[9]

This new provision, combined with the homestead amendment, if adopted, will establish a higher tax rate on commercial and industrial property than on other types of property. As a result, local voters will perceive their tax cost of local government initiatives to be lower than when all property was taxed at the same rate. Voters will see part of the tax burden as being shifted to commercial and industrial property. It is possible that many businesses will be resigned to such property classification because of perceived benefits from money raised for transportation and the inability to change location because of loss of customers if the business were moved to a different jurisdiction. However, there may be some existing businesses that would seek a lower tax jurisdiction and some potential businesses that would be deterred because of the higher taxes.

Conclusion

The proposed homestead amendment would represent a major change in Virginia local government finance since it is aimed at the real property tax, the most important single source of locally raised revenue. Although the analysis in this article pertains to cities and counties, the amendment would also have a significant impact on town finances. Given the large rise in property tax levies during most of the new century, it is not surprising that taxpayer frustration has found its way into the proposed amendment. It is unfortunate that a simpler solution—restraint on spending by local government—was not adopted. Instead, market-driven increases in assessed values were used to bring in significant amounts of new revenue.

In 2006, more than a quarter of Virginia households were renters.[10] The homestead amendment would provide no relief to renters even though a major portion of property taxes on rental property is shifted to them.

An alternative to the proposed amendment would be a state-financed circuit breaker that could be designed to provide tax relief to low-income households that are homeowners or renters.[11] Another consideration is that as the revenue-raising power of the property tax is diminished, the pressure to allow local governments a new source of revenue, such as a local income tax, will increase.

Should the amendment become part of the Constitution, the General Assembly should pass enabling legislation that is devoid of many special provisions regarding length of residence, household income, and other factors that could add to the complexity and cost of local tax administration. Whatever exemption a local government adopts will have a ratchet effect—once established it will not be reversed.

Differential taxation of property not covered by the homestead exemption may convey an unwanted message about the tax friendliness of Virginia's local tax system, especially if the implementation of special surtaxes on commercial and industrial property for funding transportation projects spreads.

As noted, the earliest that the amendment could be implemented would be 2009. Housing market turmoil, which is currently having a very negative effect on property tax collections, is unlikely to be over at that time. Thus, the amendment will exacerbate an already difficult time for local governments.

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ABOUT THE AUTHOR: John Knapp is a professor emeritus at the University of Virginia and senior economist with the Cooper Center. He is an expert on Virginia state and local government finance and has served as a member or advisor to numerous study groups over the past forty-five years.

exe?071+ful+CHAP0896 (1/4/08)

9 Information from Tom Rice, Director, Arlington Department of Real Estate Assessments (1/18/08)

10 According to the Bureau of the Census, renters accounted for 28.9 percent of Virginia households in 2006. http://www.census.gov/hhes/www/housing/hvs/annual06/ann06t13.html (1/16/2008).

11 For a recent survey of circuit breakers see Karen Lyons, Sarah Farkas, and Nicholas Johnson. *The Property Tax Circuit Breaker: An Introduction and Survey of Current Programs* (Center on Budget and Policy Priorities (March 21, 2007) http://www.cbpp.org/3-21-07sfp.htm (1/22/2008). See also a presentation by David Baer for AARP "State Programs & Practices for Reducing Residential Property Tax" at a 10/6/05 Property Tax Summit. http://ppa.boisestate.edu/centerppa/documents/20051006pm0315-baer.pdf (1/23/08)