

# Policy Memorandum

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**SUBJECT:** Capping the Increase in Property Tax Assessments

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There are two alternative approaches to limiting the increases in property tax assessments. One approach applies the limit to each parcel while the other limits the increase in the aggregate. This policy memorandum addresses the relative advantages of the two approaches.

Under both approaches, increases in property value due to new construction or renovation are not included in the limits. (To simplify the discussion, we assume there is no such new construction.) The limit applies to the inflationary increase in property value.

Under the first approach, the increase in assessment on each parcel is capped at some percent, for example, the increase in the consumer price index. (The actual proposal currently under consideration applies only to residential property.) The property tax base thus increases by the sum of the capped increases. (Once the property is sold, the assessed value reverts back to the full value.)

For example, suppose that in 2003, the total assessed value equaled \$100 and was comprised of two properties assessed at \$50 each. (If the assessment ratio is 40 percent, then the market value of the two properties are both \$125.) Suppose in 2004 the market value of one the properties increased to \$175, which converts to an assessed value of \$70 (= 40% of 175), while the second one did not change. Total assessed value before the cap is now \$120. Suppose the allowable increase is 5 percent. Thus, the assessed value of the second parcel can increase by only \$2.50. Thus, the assessments on which the tax is imposed are \$50 and \$52.50, for a total tax base of \$102.50.

Under the second approach, which is used in Iowa, the increase in total assessment is capped at some percent, for example, the increase in the consumer price index. Under this approach each parcel is first assessed at its full value and the total assessed value for all parcels is calculated. If the increase in total assessed value exceeds the allowable percentage increase, then all assessments are reduced by the same percentage. The percentage reduction equals the ratio of the allowable property tax base (i.e., the previous year's value times the allowable increase) divided by the actual assessed value. Thus, using the same example as above, the assessed value of both properties are reduced by .875 (= \$105/\$120). The final assessed value of the first parcel is thus \$43.75 while it is \$61.25 for the second, for a total assessed value of \$105. Under this approach, the assessed value of any parcel does not revert back to full assessment when it is sold.

Another way of thinking about this cap is that the assessment ratio is reduced each year to account for the property value inflation in excess of the allowable increase. Thus, in 2004, the assessed value is in effect based on an assessment ratio of 35 percent (\$125 times .35 is \$43.75, while \$175 times .35 is \$61.25). Because of differences across jurisdictions in how property values change, the effective assessment ratios will differ across jurisdictions.

What are the implications of the two options?

1. Approach one limits the increase for every taxpayer. Thus, in the above examples, the second parcel experiences a much smaller increase under approach one than under the second approach.
2. The first approach institutionalizes existing inequities in the assessments. For example, suppose that in the above example the second parcel should have been assessed at \$60 in 2003. There is no way of correcting that error by reassessing until the property sells. In the second approach, each parcel can be assessed each year based on fair market value, and thus, any assessment error in one year can be (potentially) correct in a subsequent year.
3. The first approach results in a reduction in uniformity within a jurisdiction. Under the first approach if there was no cap, then in 2004 the second parcel would pay 40 percent more taxes than the first parcel. But because of the cap it would pay only 5 percent more. In the second approach, the uniformity is retained; \$61.25 is 40 percent more than \$43.75. Thus, in the second approach taxes paid are in proportion to market value of each parcel.
4. Since in the first approach the assessed value reverts back to 40 percent of fair market value when the property is sold, equivalent property could be taxed at substantially different rates. A property that has not sold for a long time will have a much lower assessed value than an equivalent parcel that just sold. Since this does not happen in the second approach, there will be no such inequity between parcels within the same jurisdiction.
5. The first approach applies only to residential property, while the second approach applies to all property. Thus, under the first approach the percentage of property taxes paid by business will increase, but not under the second approach.
6. Both approaches will lead counties to assess property each year in order to capture the allowable increase in property value. If a county skipped a year, it cannot increase the assessed value by the two times the cap.