Introduction

In recent years real property tax assessments and levies (tax bills) have grown rapidly. Part of the growth has been due to the addition of new properties on the tax rolls and the upgrading of existing houses and other real estate, but much of the gain has been a reflection of higher prices for existing homes. Obviously, Virginia local governments have taken advantage of the housing boom to increase tax collections. Theoretically, local governments did not have to set rates that would yield large gains in revenue. They could have adjusted their rates downward so that tax collections would not grow rapidly. In fact, many cut their rates, but because of the inflation of residential values, tax levies grew strongly even with lower nominal tax rates.

The housing boom is a nationwide phenomenon; property-tax dependent governments everywhere have benefited from the rise. In reaction, several states have considered various types of tax relief programs and restraints on property tax growth. Virginia is no exception. In the current gubernatorial campaign both major party candidates have proposed Constitutional amendments with the intent of slowing property tax growth.

The purpose of this article is to review the importance of the real property tax in Virginia, to consider tax relief programs now available, to evaluate the proposals by candidates Timothy M. Kaine and Jerry W. Kilgore, and to provide information on an alternative form of relief.

The real property tax is the single most important source of tax revenue in every city and county except a few localities in the southwest that employ coal severance taxes. The tax is also the most important source of tax revenue for all of the large incorporated towns. In FY 2004 the real property tax combined with the closely related tax on public service corporation property accounted for more than half of the tax revenue for the average city and county, and 28 percent of tax revenue for the average large town (Table 1).

For most local tax sources, tax rates are strictly controlled by state statute. For example, the local option sales tax is capped at 1 percent, and local business license tax rates and consumer utility tax rates cannot exceed state limits. In contrast, local governments are given complete leeway in establishing local real property tax rates.

The District of Columbia publishes an annual nationwide comparison of tax rates based on taxes in the most populous city in each state. In Virginia, the city of Virginia Beach has the largest population. According to the most recent study, the city’s effective tax rate on real estate was $1.11 per $100 of market value in 2003. The effective rate is the statutory (nominal) rate adjusted for the average ratio of assessed value to market value. For example, if a locality had a statutory rate of $1.00 per $100 of assessed value, but assessed at 50 percent of market value, the effective rate would be $0.50 per $100 of market value. Virginia Beach’s effective rate was 74% of U.S. National Tax Burden Amount Average Rank*.

2 The Bureau of the Census includes all types of property taxes in its measure. Thus, property taxes reported for Virginia include those on real estate, public service corporations, personal property, machinery and tools, and merchants’ capital.

3 The effective rate for Virginia Beach provided in the District of Columbia study was well above the $1.00 rate measured by the Virginia Department of Taxation in The 2003 Virginia Assessment/Sales Ratio Study (September 2005), p. 24. http://www.tax.virginia.gov/Web_PDFs/2003ratio study.pdf (9/22/05).
percent of the national median and placed forty-second in a ranking from high to low.

A recent study by the Virginia Department of Taxation showed that the average effective rate in 2003 for the 134 cities and counties was $0.79. Among the 134 cities and counties, the effective rate ranged from $0.33 in Mecklenburg County to $1.33 in Petersburg city. Even though Virginia effective rates are relatively low, when they are combined with high property values as in Northern Virginia, the resulting tax bills can be substantial.

**Quality of Property Tax Administration**

In Virginia, real estate is assessed locally except for public service corporation property that is assessed by the State Corporation Commission or the Department of Taxation. Localities assess under requirements established by the state Constitution and statutes. All of the populous cities and counties reassess either annually or biennially and have full-time assessors; however, some of the rural counties reassess as infrequently as every six years and do not have full-time assessors. From a statewide perspective, property tax administration is good because the localities that reassess either annually or biennially account for more than four-fifths of taxable assessed value in the state. Property tax administration could be improved by requiring more timely reassessments by the localities that do not reassess often. Without frequent reassessments, the equity of the tax is likely to diminish because the market values of individual properties do not change at a uniform rate.

Ironically, a local assessor who does a fine job of keeping up with market values may be very unpopular with local property owners who are glad to be occupying increasingly valuable properties but concerned about the implications for their tax bills. Actually, the local assessor does not determine tax bills. It is the local governing body that sets the tax rate. If the tax rate is adjusted downward, it is possible to have a higher assessed value with no increase in the tax bill.

**Existing Property Tax Relief in Virginia**

Virginia has several property tax relief programs, all based on local option and financed locally. In addition, the state has a “truth in taxation requirement” that is discussed later in this article. The local options are:

- **Use-value Assessment**: Use-value assessment is a form of tax relief for agricultural, horticultural, forest, and open space land. Qualifying land in jurisdictions using the program is assessed at “use-value” rather than market value. Although use-values are derived by various formulas, the valuations are fictitious since there is no market test. Ostensibly, use-value assessments are intended to stop or slow the conversion of properties to residential, commercial, or some other competing use. In practice, use-value assessment is mainly a form of tax relief for the affected owners since there is only a small penalty, in the form of interest on unpaid back taxes for five years, if the land is converted by current owners or their heirs. Use-value assessment has been popular nationwide and in Virginia. Currently, in Virginia 14 cities and 70 counties provide for agricultural use-value assessments, the most frequently used form.

- **Tax Relief for the Elderly and Disabled**: Virginia has adopted guidelines for localities wishing to provide locally financed property tax relief for elderly and disabled persons meeting certain limits on their net worth (exclusive of house value) and annual income. Thirty-seven cities and 81 counties have adopted some form of tax relief for the elderly and disabled although in many cases the local ordinances provide for less relief than permitted by the state guidelines. A handful of localities also offer tax relief for renters.

- **Tax Deferral**: State law permits locally financed tax deferral for owners whose tax bills rise more than 5 per cent in a given year. The taxpayer is not excused from paying the tax. Instead, the unpaid tax liability accumulates at interest until the owner sells or dies. No locality has a deferral plan in operation. The fact that

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5Public service corporations include electric power and distribution companies, gas and pipeline distribution companies, gas and product pipeline transmission companies, public service water companies, telephone and telegraph companies, and railroads.
advocates for property tax relief have not pushed hard for deferral proves that tax reduction is much more valuable than a loan.

Rehabilitated Property, and Property Used for Special Purposes: State law permits localities to adopt ordinances allowing property tax exemptions for certain rehabilitated commercial and industrial real estate and residential real estate. To be eligible for the exemption, the rehabilitated structure must be at least 15 years old if it is residential property or 20 years old if it is commercial or industrial property and the property must meet other restrictions that a locality may require. Special exemptions are available for property used for pollution control, recycling, solar energy, and energy conservation.

2005 Gubernatorial Campaign Property Tax Proposals

The two principal candidates for governor have made proposals for constitutional amendments that would have a major impact on the local property tax, although not for several years because the amendment process would consume at least three years.

Kaine’s proposal would allow local governments to exempt up to 20 percent of the assessed value of residential owner-occupied properties. Localities would continue to set the rate. Therefore, if the local government chose to raise the same amount of property tax revenue as before, it could raise the rate to compensate. In effect, the tax burden would be redistributed with a much heavier incidence on residential rental property, commercial property, and industrial property. Also, this would create differential taxation. Owner-occupied residential property would have a lower effective rate than other types of real property.

The “cost” of the Kaine proposal cannot be estimated realistically without making many assumptions. If all local governments participated, and if they did not attempt to replace the lost revenue with a higher real property tax rate or with other tax and nontax sources of local revenue, then the foregone amount of tax revenue would be very large. In 2004-2005, single-family residential property accounted for 71 percent of statewide taxable assessed value. This would have resulted in a tax cut of $988 million, an amount equal to 17 percent of real property taxes imposed in tax year 2003. However, this is an extreme estimate because it is very unlikely that all local governments would participate, that all governments granting an exemption would allow a full 20 percent, and that governments granting an exemption would not take other actions to replace all or part of the foregone revenue.

Kilgore’s proposal would require local governments to limit annual increases in assessed value of residential owner-occupied properties to 5 percent. Localities reassessing less frequently would be limited to the 5 percent rate compounded as shown in the Table 3.

<table>
<thead>
<tr>
<th>Frequency of Reassessment</th>
<th>Maximum Permitted Increase in Assessed Value</th>
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<tbody>
<tr>
<td>Every year</td>
<td>5%</td>
</tr>
<tr>
<td>Every two years</td>
<td>10%</td>
</tr>
<tr>
<td>Every three years</td>
<td>16%</td>
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<tr>
<td>Every four years</td>
<td>22%</td>
</tr>
<tr>
<td>Every five years</td>
<td>28%</td>
</tr>
<tr>
<td>Every six years</td>
<td>34%</td>
</tr>
</tbody>
</table>

For example, if a locality reassessed every four years, the increase in assessed value of an individual property would be limited to 22 percent. As under the Kaine proposal, localities could raise the property rate to compensate for the foregone revenue if increases in assessed values exceeded the limit. This could lead to a differential tax system with lower effective rates for owner-occupied residences exceeding the limit than for all other property—

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9Effective rate = nominal rate X (assessed value/market value). If the assessed value is reduced by 20 percent, the effective rate will be lowered for that property.
11The estimate was derived by assuming 20 percent of owner-occupied residential property would be exempted and that the relevant tax rate on taxable assessed value would be $1.03 per $100. Sources: Knapp, Classification of the Assessed Value of Locally Assessed Real Property in Virginia and Virginia Department of Taxation, Annual Report, Fiscal Year 2004 (Revised 9/28/05) http://www.tax.virginia.gov/Web_PDFs/AnnualReportFY2004.pdf (10/12/05).
Alternatives to Kaine and Kilgore Proposals

The first alternative is to do nothing. Virginia has a “truth in taxation” provision in state law. The law requires local governing bodies to reduce their tax rates so that tax collections will not go up more than 1 percent over the previous year, unless there is a public hearing and government sponsored advertisements in local newspapers with information about the rate that would raise the same amount as the previous year and the proposed rate.\(^\text{12}\)

If a local governing body wants to take the heat from establishing a rate that will result in a larger increase in revenue then that is its prerogative. It is also the prerogative of the local voters to express their displeasure in the next election. If we believe in responsible local government, we must provide local governments with revenue raising powers consistent with the challenges they face. Because of the importance of the property tax, any effort to restrict local government control of the tax will undermine local government finances.

The second alternative is to adopt a state-financed property tax circuit-breaker, so named because it would provide relief (break the circuit) if the property tax bill exceeded a certain percentage of income. Such a plan would bear some resemblance to locally financed programs now in existence for the elderly and disabled. A circuit-breaker could be implemented next year since it would not involve a constitutional change. A few states have adopted broad plans that apply to all property tax payers, not just the elderly and the disabled. And some states have included relief for renters. The plans require a state unit to administer the program and a process for annual applications and verification of information submitted. Apart from administrative cost, the cost of such a program would be dependent on the specific relief offered. Costs in four states with programs—Maine, Maryland, Minnesota, and Wisconsin—are instructive. The homeowner tax relief programs ranged in cost from $28 per household in Maryland to $261 in Maine (Table 5). The renter relief cost ranged from $67 per household in Wisconsin to $165 in Maine. Maryland does not offer a renter relief program.

To make a crude estimate of the total cost for Virginia, I multiplied the per household costs by the number of households in Virginia. Based

\(^\text{12}\)Code of Virginia § 58.1-3321.
on the generous Maine plan for homeowners, the cost to Virginia state government of such a program would be $503 million. The much more modest Maryland plan would cost $54 million. Minnesota’s renter relief program is the most expensive, costing $250 million if implemented in Virginia. For the other two states with rental relief, the Virginia cost would be $142 million based on the Maine plan and $58 million based on the Wisconsin plan. As shown by this information, the cost to Virginia of financing local property tax relief would depend entirely upon the features of the legislation. The cost could be formidable, as illustrated by the Maine plan, or fairly manageable for a Maryland-style plan that is modest and restricted to homeowners.

### The Housing Boom

For the last two years a staple article in the national and regional press is the buoyant market for houses. House prices have been rising sharply. A house price index for Virginia rose by 15.1 percent in 2004 and at an annual rate of 20.2 percent in the first six months of 2005. Gains have been particularly strong in the metropolitan areas of Northern Virginia, Winchester, Hampton Roads, Charlottesville, Harrisonburg, and Richmond.

There is much discussion as to whether or not there is a housing “bubble.” Even the optimists who deny a bubble assume that the current pace is unsustainable. An abrupt increase in mortgage rates, a tightening of lending criteria, or difficulty for housing investors in selling properties are all factors that could slow or stop the current heady growth of housing prices.

The main consideration for Virginia local government finance is that, in recent years, localities have benefited from the booming housing market because local tax rates have not been adjusted downward to fully compensate for the increases in assessed values. This condition will

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**Table 5. Annual Cost of a Virginia State-Financed Circuit-Breaker Based on Programs of Four States**

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<th></th>
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<tbody>
<tr>
<td>Homeowners</td>
<td>$261</td>
<td>$28</td>
<td>$75</td>
<td>$31</td>
</tr>
<tr>
<td>Renters</td>
<td>$165</td>
<td>Not applicable</td>
<td>$290</td>
<td>$67</td>
</tr>
<tr>
<td>Virginia total cost Renters</td>
<td>$142 mil.</td>
<td>Not applicable</td>
<td>$250 mil.</td>
<td>$58 mil.</td>
</tr>
</tbody>
</table>


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**Percentage Change of Housing Prices in Virginia**

<table>
<thead>
<tr>
<th>%</th>
<th>90</th>
<th>91</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>00</th>
<th>01</th>
<th>02</th>
<th>03</th>
<th>04</th>
<th>05*</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
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</table>

*Annual rate for the first six months of 2005

Source: Office of Federal Housing Enterprise

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13Per household cost was calculated by dividing the total cost of the program by the number of homeowner and household households, respectively.
not persist indefinitely so local governments should be prepared for tougher times.\(^\text{14}\) The housing boom has had a favorable impact on state revenues also. It has directly affected the tax on deeds and indirectly added to sales tax collections as homeowners financed purchases with extra money from refinancing mortgages. Thus, at the very time local governments face tougher times, so may state government.

**Conclusions**

The housing boom is affecting the real property tax as required reassessments pick up the large increases in market values. This development is very important for Virginia local governments since the real property tax is their primary source of tax revenue and the principal basis for their fiscal independence. Based on national studies, real property taxes in Virginia are moderate. However, as property tax bills increase, there is widespread concern. Property tax administration in Virginia is good by national standards. The best administration occurs in the urban areas where reassessments are annual or biennial.

The property tax relief that currently exists in Virginia is locally financed. There are programs for the elderly and disabled, for rehabilitated property and property used for special purposes, and use-value assessment programs favoring agricultural, forest, horticultural, and open space uses.

However, there are no general property tax relief programs. Gubernatorial candidates Kaine and Kilgore have proposed constitutional amendments that would provide relief to one class of property: single-family, owner occupied housing. Even on a fast track, the constitutional relief would not become available for four years, by which time the condition of the housing market is likely to be far less buoyant than now. The main result of the plans would be to redistribute the property tax burden from favored homeowners to rental residential property, commercial property, industrial property, and homeowners not fortunate enough to experience significant appreciation in the market value of their properties. Both plans would be harder on localities with high percentages of assessed value in residential owner-occupied housing.

One alternative approach to the current concern about rising property tax bills is to adopt no new policies. Existing statutes require local governments to publicize increases in tax collections beyond what would have occurred by applying a lower rate to the increased value of assessments. If local elected officials feel more tax revenue is justified they are empowered to set a rate that will provide the additional revenue. In a subsequent election, local voters who disagree can register their disapproval at the ballot box.

Another approach to the property tax issue is for the state government to finance property tax relief using a circuit-breaker. Unlike the Kaine and Kilgore constitutional proposals with their long approval process, such a program could be implemented next year by state statute. The program, which could be made available for renters as well as home-owners, would involve significant administrative costs and the cost of the tax relief itself could be modest to high, depending upon the eligibility rules and the generosity of the provisions adopted.

The future course of housing prices is going to have a major impact on local government finances. The current growth rate of market values is generally considered to be unsustainable. In the future, local government will face at best lower growth rates and at worst declining values.

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\(^\text{14}\)For a thoughtful article on how local governments would be affected by a collapse of a “bubble” see: John E. Petersen, “Bubble Trouble, A Puncturing of Today’s Inflated Real Estate Values Would Have Negative and Broadscale Effects on Local Governments.” *Governing* (July 2005) http://governing.com/articles/7fin.htm (10/12/05).
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