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Political costs and fiscal benefits: The political economy of residential property value assessment under Proposition $2\frac{1}{2}$

Michael Makowsky[a], Shane Sanders[b,*]

[a] Center for Advanced Modeling, Department of Emergency Medicine, Johns Hopkins University; Davis Building, Suite 3220, 5801 Smith Avenue Baltimore, MD 21209, USA

[b] Department of Economics and Decision Sciences, Western Illinois University; 429 Stipes Hall Macomb, IL 61455, USA

HIGHLIGHTS

- We use Proposition $2\frac{1}{2}$ referendum data to estimate the fiscal cost of assessment vale increases.
- Assessors respond to both fiscal benefits and political costs of assessment increases.
- Specifically, assessors respond to signals of political cost from town property owners.
- Elected assessors are more responsive to political costs.

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ABSTRACT

We use a 15-year panel of property value assessment data from 351 Massachusetts municipalities. Appraised values grow more slowly in municipalities with elected assessors. When municipalities pass, via referenda, large increases in the cap on tax revenues, value assessments grow faster under appointed assessors and slower under elected assessors. Appraisals grow slower when alternative revenue sources are available.

1. Introduction

The assessment of property value is as much an art as it is a science. This is particularly so in small towns and rural areas, where market exchanges of property are less frequent and comparable property less identifiable. The inherent subjectivity of property assessments is of interest, given the importance of property taxes for many local and state governments, often representing the bulk of budgeted revenues.[1] Property assessors, acting as either appointed agents of government officials or elected officials themselves, have an incentive to maximize government revenues and voter satisfaction. Can changes in assessed residential property value be solely explained by changes in the real estate market, or does the assessment process present an alternative means to raise property taxes and supplement budgets for vote-maximizing elected officials? Using data from a unique legislative environment, we find evidence that assessors respond to both fiscal benefits *and* political costs of assessing a higher rate of growth in appraised property values.

There is an extensive literature on the political economy of property taxation. Strauss and Sullivan (1998) and Eom (2008) each find that appraisal uniformity is influenced by local political economy, while Bowman and Mikesell (1989) find no such relationship. In a study of Massachusetts municipalities, Brueckner and Saavedra (2001) show that local government officials consider the costs and benefits of property tax revenues, while Besley and Coate (2003) find that elected regulators are more consumer

* Corresponding author.
E-mail addresses: mmakowsky@jhu.edu (M. Makowsky), shanedsander@gmail.com, sd-sanders@wiu.edu (S. Sanders).

[1] Lutz (2008) notes that the tax accounts for approximately three-fourths of local government tax revenue. Cornia and Walters (2006) note that property taxes are often substantial enough in magnitude to cause financial hardship, especially during periods of rapidly rising property values.

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protective than appointed regulators. In a related paper that examines Virginia towns and counties, Ross (2011) finds that the method of assessor selection influences the rates of appraisal growth, as does local fiscal stress. Ross (2012) concludes that method of assessor selection influences property tax regressivity.

The hypothesis that government officials are motivated by budgetary considerations, and not just the equitable application of the law, is not without precedent. Niskanen (1971) hypothesized that bureaucrat decision-making was, at least in part, an exercise in maximizing their agency's budget. Makowsky and Stratmann (2009) find evidence of traffic citations used as a means to generate revenue when local officials are blocked from raising taxes by referendum. Garrett and Wagner (2009) similarly conclude that municipal budget deficits lead to more traffic citations. Helland and Tabarrok (2002) find evidence that elected judges were motivated by a desire to transfer wealth from non-constituent defendants to constituent plaintiffs.

In the case of property value assessment, a property assessor may be either a bureaucrat appointed by the municipal government or a non-bureaucrat elected by the townspeople. This municipal-level variation in assessor status provides an opportunity to test for the budget-maximizing hypothesis. Specifically, we test whether appointed assessors are more influenced in their assessment decisions by the budgetary concerns of their municipal government than are elected assessors. We consider some of the same issues addressed by Ross but within a unique legislative environment. The results of municipal override referenda for Proposition $2\frac{1}{2}$ in Massachusetts allow us to estimate fiscal constraints *and* preferences among both local governments and tax payers simultaneously so as to determine the effects of these variables upon appraisal growth.

We examine a 15-year panel of data of property value appraisals, with special attention paid to the effects and interactions of political structure, budgetary conditions, and fiscal institutions. We take advantage of the Massachusetts property tax institution known as Proposition $2\frac{1}{2}$ to better understand how fiscal budgetary conditions and political costs might influence appraisal decisions. We also benefit from differing rules regarding selection of town assessor: an elected position in roughly two-thirds of Massachusetts towns and appointed in all others.

Property value assessments in Massachusetts are made according to a "full and fair cash value" standard using the three common appraisal approaches: income, cost, and market. Assessors estimate the market value of a property based on either its recent sale price or the sale price of comparable properties (market approach). They also consider factors such as current cost of construction (replacement cost approach) and present financing and economic conditions (income approach). There is no precise legal standard for determining the set of comparable properties for a given property. Proposition $2\frac{1}{2}$ places specific limits on both growth in annual tax revenue and total tax revenue levied in a year. Only with the passage of an "override" referendum can a town exceed the soft limits imposed, and even then there are "hard caps" that cannot be surpassed. When such a referendum fails, the local government faces strong incentives to identify alternative sources of additional revenue. Prior studies show that Proposition $2\frac{1}{2}$ slows or decreases municipal spending (Cutler et al., 1999; Bradbury et al., 2001) and shifts municipal revenue sources (Susskind and Horan, 1983; Makowsky and Stratmann, 2009).

2. Hypotheses and empirical method

We hypothesize that incentives facing assessors, beyond accuracy and demonstrating professional acumen, fall under the rubric of political economy. A political economy model of property appraisal predicts that assessors will attempt to maximize fiscal health subject to legal and electoral constraints. Using this simple model, we arrive at several testable predictions. When assessors are appointed by elected government officials (directly elected by townspeople), they are afforded greater (less) political distance. We predict that residential property appraisals grow more slowly when assessors are elected.

Beyond property taxes, there are alternative revenue sources, some of which carry no discernible political cost to locally elected officials. Our model predicts that municipal property appraisals grow more slowly in proportion of municipal budget originating from alternative sources. The calling of an override referendum signals fiscal distress and the existence of significant fiscal benefits from generating additional revenue. The outcome of the vote signals the preferences of the constituency and their willingness to bear additional taxes. A passing override vote signals lower political costs to increasing taxes, while a failed vote signals higher political costs. The size of the request provides a sense of the relative magnitude of associated fiscal benefits and political costs. When a large dollar value override fails, this indicates greater fiscal benefit from additional revenue. The larger the passed override, however, the greater the political costs of further tax increases. Accumulating these effects, our model predicts (1) less appraisal growth with the failure of small overrides and passage of large overrides, and (2) greater appraisal growth with the passage of small overrides and failure of large overrides.

To test these hypotheses, we estimate the following regression model:

$$\begin{aligned}\text{ResidentialGrowth}_{it} &= \beta_0 + \beta_1\mathbf{Appraisal}_{it} + \beta_2\text{Elected}_i \\ &\quad + \beta_3\mathbf{Budget}_{it-1} + \beta_4\mathbf{Override}_{it-1} + \beta_5\mathbf{Municipal}_{it-1} \\ &\quad + \beta_6\mathbf{Override}_{it-1} * \mathbf{Elected}_i + \text{Municipality}_i \\ &\quad + \text{Year}_t + \varepsilon_{it}. \qquad (1)\end{aligned}$$

$\text{ResidentialGrowth}_{it}$ represents the growth in appraised value of preexisting property in town i for fiscal year t.[2] It is important to restate that the value of $\text{ResidentialGrowth}_{it}$ is not influenced by new construction, remodeling, or renovation projects. Assessed value deriving from these activities is considered "new growth" value and can therefore be separated from assessed value in the prior year. $\mathbf{Appraisal}_{it}$ is a vector of variables related to property appraisals, including non-residential growth, lagged residential growth, and changes in property exemption. $\text{ResidentialGrowth}_{it}$ is included as a control variable for the local real estate market. As local socioeconomic conditions ebb and flow, we expect non-residential property values to move in step and, in turn, in the same direction as residential property values.

Lagged residential growth controls for past indirect tax increases through property appraisal growth and constituent "fatigue". We include the change in fraction of property declared exempt from taxation to control for changes in the taxable property base. Elected_i equals 1 (0) in towns where assessors are elected (appointed). Remaining variables include lagged local fiscal and municipal conditions that may affect assessment decisions. Appraisals for fiscal year t occur in the middle of fiscal year $t - 1$. Thus, lagged values are concurrent with the assessment process.

$\mathbf{Budget}_{it-1}$ is a vector of budgetary variables. These include local receipts, free cash, stabilization fund, and state aid. Local receipts are revenues generated from court fines, excise taxes, interest, and other fines and fees. Free cash represents a municipality's remaining unrestricted funds from previous fiscal year operations. The stabilization fund represents municipal funds

[2] This variable nets out property value increases from new growth construction or renovation. Thus, it reflects appraisals of a fixed stock of property over time.