Taxes may have exacerbated housing bubble, study reports

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A new study by a UT Dallas economist found that property taxes may have exacerbated the housing bubble that began in the early 2000s and led to the Great Recession.

The study, published in *Public Finance Review*, found that property taxes did not reflect rising home values during the housing bubble. Property taxes effectively fell because they did not keep up with the market changes.

When that happened, property taxes made up a smaller share of a home's total cost. And that helped fuel demand, said the study's author, Dr. Seth Giertz, professor of economics in the School of Economic, Political and Policy Sciences.

"If you're looking to buy a house and there's a lower tax rate associated with it, you're willing to pay more for the house," he said.

The problem came when the bubble burst. The study found that property taxes increased when house prices declined. In some cases, governmental entities raised property taxes to make up for dropping revenue. In others, governmental entities did not reassess homes to reflect their lower values, Giertz said.

"On the downside, when house prices are falling, the effective tax rate is going up," Giertz said.

The effective property tax rate is the amount of taxes that a homeowner pays divided by the market value of the home.

For the research, Giertz and a co-author looked at the role local market conditions played in determining the magnitude of the bubbles and busts. They examined how property taxes interact with housing price fluctuations in major metropolitan areas between 2005 and 2010. They found that the inverse relationship between property taxes and home prices may help inflate housing bubbles—and slow their recovery after a bust.

The housing bubble that began in the early 2000s has been attributed to a variety of factors, including subprime lending, historically low interest rates and population growth. The paper emphasized that property taxes were not a major contributor to the bubble. But the authors say that property tax reforms could allow taxes to mitigate, rather than exacerbate, bubbles and busts.

"Especially during the bust, property tax practices made things worse, as many communities either substantially cut public services and/or substantially raised property tax rates at a time when many in the community could least afford it," Giertz said. "Many times, increases in property tax rates came about not from legislated tax increases, but from keeping assessed property values at well above properties' true market values."

Effective property tax rates rose the highest in areas that also experienced the greatest declines in home prices when the bubble burst, according to the study. Detroit's effective tax rate increased 1.16 percentage points, while its home prices dropped 34 percent. Other cities with the largest increases in effective property taxes were hardest hit by the crisis, including Las Vegas, Riverside, California, and Fort Lauderdale, Florida.

The new study highlights the differences in how the housing bubble played out in various regions of the country. The researchers cautioned against forecasting housing bubbles based on the concept of a national housing market. Instead, they conclude that regional strategies are needed.

"One area of the country could be experiencing a bubble, and another could be having a flat period," Giertz said.

Possible policy responses could involve increasing property tax rates when home prices increase and lowering them during down swings, he said. The "buffer" in revenues on the way up could be used during the downswing, in lieu of raising tax rates, he said.

More information: J. R. Follain et al. US House Price Bubbles and Busts: Implications for Property Taxation, *Public Finance Review* (2014). DOI: 10.1177/1091142114537674

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