

ECONOMIC BRIEF NO. 18

Property Value & Tax Changes

The market value of any property is determined by its annual rental value and the costs associated with owning or using it.

Any time tax rules change, some people gain and some people lose. As the General Assembly considers property tax relief proposals, this fact has received little attention.

Economic theory tells us that a reduction in the property tax will increase the market value of property, and an increase in the property tax generally reduces

Cutting the property tax reduces the costs of owning and using a property and so increases the net rental value. An increase in net rental value in future years increases the selling price of that property right now, because it comes with a lower tax burden than it did before. The value of that onetime jump in property values accrues to the owners of real property at the time property taxes are eliminated or reduced. But those who might be thinking about buying residential property in the future will find the price tag on houses has increased.

Eleven studies of real world situations* indicate that this capitalization process isn't just imagined by economists. It really happens. However, the studies differ in their conclusions about how much of the tax change is reflected in the market price. In some cases it's 100 percent of the tax change; other studies show as little as 50 percent.

All eleven studies, however, concluded that a substantial part of property taxes is capitalized into property values. That is, a change in taxes becomes part of the value of the property.

Based on these studies, it is reasonable to expect that if property taxes were cut in half in South Carolina, the market value of a \$100,000 owner-occupied house would increase by about four to five thousand dollars. If property taxes were elim-

inated all together, the increase would be on the order of ten thousand dollars.

Similar kinds of increases in market values would be seen for other types of property benefiting from tax changes. The existing owners of property reap all the benefits or bear all of the burden, in perpetuity, resulting from changes in rates.

Does this mean that eliminating property taxes in South Carolina will make it harder for first-time house buyers to make a purchase? It almost certainly means they will pay more for a house. The down payment will have to be larger; and because a mortgage is also likely to be larger, monthly payments will be higher. Much of what they would have paid in taxes will now be allocated to these higher costs. They will get some relief from lower annual taxes on the house, but this relief may or may not offset higher mortgage payments.

Yet if eliminating property taxes is likely to be adverse to interests of first-time home buyers, elimination will almost certainly benefit real estate brokers, who will realize larger commissions from selling higher priced property. Lenders should also benefit from interest on larger mortgages. Of course, sellers who own property when the property tax is eliminated will realize substantial windfall gains.

John Yinger, Howard S. Bloom, Axel Borsch-Supan, and Helen F. Ladd, *Property Taxes and House Values*, Boston, Academic Press, pp. 16-36.

... sellers who own property when the property tax is eliminated will realize substantial windfall gains

property values unless the higher taxes are dedicated to things that enhance property values, like sidewalks and street lights. This change in property values is called *capitalization*.

The market value of any property is determined by its annual rental value and the costs associated with owning or using it. Even if a property isn't rented now, it may be rented in the future. It also has rental value to the current owner who gets to use it without actually paying rent.

A property's rental value can be viewed as a stream of future payments just like buying a bond or putting money in a certificate of deposit creates a stream of interest payments. Since payments in the future are worth less than today's, they are discounted. So the value of property is the sum of those discounted future payments.

In furtherance of Clemson University's land-grant mission, the Community & Economic Development Program at Clemson provides access for community leaders in South Carolina to expertise in all branches of knowledge on the University campus.