Indiana Property Tax Caps: Using Dollars and $ense to Make the Right Decision

POLICY BRIEF JANUARY 26, 2010

Property Tax Reform in Indiana

In March 2008, the Indiana General Assembly enacted legislation overhauling the State's property tax system. The purpose of the "1-2-3" legislation as it has come to be known, was to cap property taxes for homeowners, rental property owners, and businesses at 1%, 2 %, and 3% of assessed value, respectively. While property taxes were reduced for many Hoosier homeowners, these tax cuts were paid for through an increase in the state's sales tax and the elimination of a number of existing property tax relief mechanisms. So in actuality there was primarily a tax shift rather than a tax cut.

As a result, there was a shift in overall tax liability from homeowners to renters. One estimate found that as many as 60% of Indiana renters would pay *more* in taxes under the restructuring, while close to 80% of homeowners would pay *less*.[1] This means renters are shouldering the cost of property tax relief for homeowners.

This brief outlines the March 2008 legislation and discusses whether a key component of the property tax restructuring — the caps — should be placed in the State's constitution.

Who Really Benefits from Homeowner Property Tax Relief?

Indiana's property tax exemptions are more costly than almost any other states. As a result of the "homestead standard deduction," homeowners are allowed to exempt the first $45,000 of their home's value from their property tax liability. In addition, the March 2008 legislation allows the next $600,000 of a home's value to enjoy a "supplemental homestead deduction" of 35%. Finally, for those fortunate Hoosiers with homes valued of more than $645,000, any amount of value above that level is reduced by 25%.

The combination of these deductions has significantly lowered homestead property tax bills by sheltering enormous amounts of property value from taxation. According to the Census Bureau, the median Indiana homestead was worth $125,200 in 2008. After applying the standard and supplemental deductions to that value, only about $52,130 of that home's value is subject to property tax. Put another way, almost 60% of the median's home value is exempt from tax.[2] By taxing homes on such a small percentage of their overall value, Indiana's property tax system departs significantly from the basic principle that property taxes should be levied as a tax on property's actual value.

The $45,000 standard deduction is particularly beneficial to low- and moderate-income homeowners as it represents a larger share of their property taxes and income. However, the percentage exemptions contained in the property tax reform, of 35% and 25%, are most valuable to high-income homeowners with high-priced homes. For example, a $1 million home in Indiana is only taxed on $656,250 of its value after the standard and supplemental deductions are applied. That's an exemption from tax of close to $350,000. Compared to Indiana's median home value of $125,000, the typical $1 million home is allowed a tax exemption that's almost three times larger than the entire price of the median home!

---

[1] Larry DeBoer. Purdue University.
http://www.agecon.purdue.edu/crd/localgov/Topics/Essays/Tax_Reform_Households_0408.htm

[2] And, to the extent that homes are assessed at below market value, even more than 60% of actual value may be excluded from taxation.

PREPARED BY:

INDIANA INSTITUTE FOR WORKING FAMILIES

WITH TECHNICAL ASSISTANCE FROM ITEP

Indiana's Property Tax Caps

Layered on top of the homestead tax breaks is another form of relief — the tax caps, which are being referred to as circuit breakers. The term "circuit breaker" is properly applied only to measures designed to prevent property taxes from growing too large relative to a homeowner or renter's household income. Under a true circuit breaker, if property taxes become too high relative to a family's budget, the circuit breaker kicks in and refunds any property taxes above a given percentage of income. In Indiana, however, the term is incorrectly applied to a system of property tax "caps." These caps are not based upon a homeowners' ability to pay, but instead prevent property taxes from exceeding a certain percentage of a property's value.

Beginning in 2010, the 1%, 2%, and 3% caps will be in effect. Homesteads can be taxed at no more than 1% of their assessed value, other residential properties (mainly rental units) and agricultural land cannot be taxed above 2% of their value, and other forms of property cannot be taxed at more than 3% of value. In 2009, the caps were in the process of being phased-in, and were set at 1.5%, 2.5%, and 3.5%.

While most of the scrutiny has been placed on the tax caps, they have, up until this point, had little impact on homeowners' tax bills. In 2009, only 2.7% of all property tax cap credits were distributed to homeowners via the 1.5% homestead cap. Instead, the vast majority of the tax cap credits (97.3%) were given to owners of property taxed under 2.5% and 3.5% caps. This is because the generous homestead deductions reduced homeowner property taxes so starkly that the caps were rarely needed. In other words, the homestead deductions alone generally reduce homeowner property taxes below 1.5% of assessed value.

However, the use of the tax cap credits could change dramatically in 2010. A March 2009 analysis, by the Indiana Legislative Services Agency (LSA), estimates that the cost of the homestead tax caps could grow by nearly 600% when the homeowners' cap is tightened from 1.5% to 1%.[3] Since that tightening will not take place until the March 2010 assessment, substantial uncertainty exists regarding the caps' eventual effect on local governments' budgets, though it can be assumed that those effects will be substantial.

In the meantime, it is certain that the caps will continue to primarily benefit Hoosiers living in more expensive homes. Recall the two examples previously discussed: the $1 million home taxed on $656,250 of its value, and the $125,200 home taxed on $52,130 of its value. Applying a hypothetical 2% tax rate to each of these home's taxable values will result in tax bills of $13,125 and $1,043, respectively. Under a 1% tax cap, the $1 million home's tax bill will be prevented from rising above $10,000, while the $125,200 home's bill would be unaffected. This example supports one Purdue University researcher's findings that higher-valued homes are much more likely to benefit from the caps.[4]

---

[3] http://www.in.gov/legislative/pdf/PropertyTax_Estimates_By_PropertyClass_CurrentLaw_20090323.pdf

[4] Larry DeBoer. Purdue University.
http://www.agecon.purdue.edu/crd/localgov/Topics/Essays/Tax_Reform_Households_0408.htm

Should Property Tax Caps Be in the State Constitution?

The next stage of the property tax debate requires deciding whether or not to place the tax caps of 1%, 2%, and 3% in the State constitution. Lawmakers have voted in favor of adding the caps to the constitution and the issue will now be referred to the voters for final approval via referendum.

A number of persuasive reasons exist for forgoing the addition of these caps to the constitution:

- The fully phased-in 1%, 2%, and 3% caps will not be implemented until the March 2010 assessment, and their full range of effects, including their impact on local services such as schools and fire and police protection, and road maintenance, will not be clear until much later. Protecting these untested provisions from future alteration is unnecessary and irresponsible.
- A huge and unsettling share of Indiana property value has been exempted from the property tax leaving the state with less revenue to fund essential services such as education.
- The property tax caps and homestead exemptions are inequitable as they continue to allow larger exemptions for even the most valuable homes (those worth more than $645,000).
- The cost of the property tax relief for homeowners has been shouldered by higher tax liabilities for renters.
- The property tax caps are already in Indiana state law (statute). Adding the caps to the constitution ties the hands of future Hoosiers, and their representatives, to adjust the property tax caps in times of economic distress as it would take two legislative sessions to make changes to the caps if they are in the State constitution. Additionally placing them in the State constitution does not provide any added benefit to Indiana families today!

INDIANA INSTITUTE FOR WORKING FAMILIES

The Indiana Institute for Working Families is a program of the Indiana Community Action Association, Inc. (IN-CAA). The goal of the Institute is to help Hoosier families achieve and maintain economic self-sufficiency. The Institute is the only statewide program in Indiana that combines research and policy analysis on federal and state legislation, public policies and programs impacting low-income working families with education and outreach. The Institute achieves its work by focusing its activities in the following areas: public policy research and analysis; advocacy, education, and information; and national, statewide, and community partnerships.

To learn more about the Institute and their research, please visit: http://www.incap.org/iiwf.html.

For More Information, Please Contact Us At:

1845 W. 18th St.
Indianapolis, IN 46202
Phone: (317) 634-4232
Email: ltravis@incap.org
Web Site: www.incap.org