**The Coming “Great Compression” in Residential Real Estate**

**(and the Burden of a Great Public School System)**

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Because one of the most progressive taxes in America is the property tax, a compression in housing values – as market prices for low-end housing stabilize and even begin to rise in many areas while market prices for high-end properties continue to decline – is about to produce two surprises:

·         a shift in the tax burden from higher-end homeowners to lower-end homeowners; and

·         unrelenting upward pressure on education budgets as growth in public-school enrollment continues to exceed expectations.

Property taxes are a “flat” tax, meaning that the same rate applies to everyone.  However, rich people like to live in big, expensive homes, so they pay substantially more taxes per capita, even though they generally demand no greater municipal services (police, fire, recreation, roads), and even though they have historically demanded less educational services because many of them send their kids to private schools.  In so doing, they subsidize lower-end home owners in their community.

For any given community, the magnitude of the “subsidy” paid by higher-end home owners is determined primarily by the mix of housing.  For example, if all houses in a town are identical (think: Levittown), then everyone pays exactly the same taxes.  Also, if there are only a few higher-end homes, their owners will pay a significant tax premium, but because there are not many of them, the total subsidy will not amount to much for each of the low-end homeowners.  Likewise, if there are only a few lower-end homes, each of them will benefit significantly from the higher taxes paid by most homeowners in their town, but the total subsidy again will not be substantial.  The gap between the mean and the median home values in a community is one measure of the subsidy being paid by some homeowners on behalf of others.

A second important determinant is the size of a town’s budget.  For example, a small rural town with an older population, few school-age children and limited public services will have a very small budget and therefore will not have the potential to impose much of an unequal burden.

The third major influence is the degree to which a community depends on residential as opposed to commercial property taxes.  Even if a town has a large budget and a wide range of residential property values, it may derive most of its tax revenues from commercial property owners, who therefore pay most of the subsidy for lower-end residential home owners.

In Fairfield, with its diverse housing-mix (i.e., homes ranging value from ~$200,000 to $35 million), its large budget (due primarily to having lots of kids in its fine public schools and thus an education budget of $146 million that is now much larger than its municipal budget of $117 million), and its low commercial tax base (only 10% of the Grand List), the subsidy paid by the higher end is significant.

The actual numbers look like this: Fairfield’s total budget for the 2012 fiscal year is **$263 million**, including **$146 million** to educate 10,162 students (representing a cost per student of $14,367)[1][1]; and **$117 million** for everything else.  If we subtract the ~**$25 million** in taxes paid by owners of commercial and industrial properties, ~**$15 million** in taxes paid on motor vehicles and personal property, and  another ~**$24 million** in revenues from non-tax sources (like fees and state grants), the balance to be paid by residential property owners is **~$200 million**.

To raise this $200 million from the ~20,000 residential property owners (20,151 according to the Tax Assessor), each of them must pay on average ~$10,000.  What each property owner actually pays is obviously based on the value of his/her home.  The assessed value of all the residential real estate in Fairfield as of October 2010 (a.k.a., “The Residential Grand List” or “R.G.L.”) was ~$9 billion.[2][2]  Since the assessed value is 70% of the estimated market value, the market value of the average Fairfield home was ~$650,000 ($450,000 = 70% of $643,000).  The tax rate (a.k.a., the “mill rate”) of 22.47 (which applies to all property, both commercial and residential) for the 2012 fiscal year produces in the required average tax of ~$10,000 (i.e., $450,000 x .02247 = $10,115), and the required total of $200 million.  The average home market value of ~$650,000 is ~30% higher than the median home market value of ~$500,000, on which the taxes are ~$7,900 (i.e., 70% of $500,000 = $350,000 x .02247 = $7,865).

A breakdown by value of higher-end Fairfield residential properties is as follows:

  10  >$10 million in market value with aggregate assessed value (70% of market value) of $117.5 million

    3  between $9m and $10m in MV with AAV of $19.8m

    4  between $8m and $9m in MV with AAV of $23.3m

    5  between $7m and $8m in MV with AAV of $26.0m

  12  between $6m and $7m in MV with AAV of $57.5m

  17  between $5m and $6m in MV with AAV of $65.6m

  42  between $4m and $5m in MV with AAV of $132.4m

  69  between $3m and $4m in MV with AAV of $170.4m

  94  between $2.5m and $3m in MV with AAV of $181.0m

203  between $2.0m and $3.0m in MV with AAV of $319.7m

482  between $1.5m and $2.0m in MV with AAV of $590.5m

In summary, there are 941 properties with market values of >$1.5m each and an aggregate assessed value of $1,704 million.[3][3] Thus, although they represent only 5% of total Fairfield homes (941 / 20,151 = 4.7%), homes worth >$1.5m each in market value account for ~19% of the total $9 billion value of the Residential Grand List ($1,704 / $9,033 = 18.9%).  These higher-end homes therefore pay ~19% of total residential property taxes, or ~$38 million in the aggregate and an average of ~**$40,000** each ($38m / 941 = $40,382).  The other ~19,000 homes pay ~$162 million in aggregate taxes and an average of **~$8,400** each ($162m / 19,210 = $8,433).

Even factoring in taxes on motor vehicles at $500 per residential unit (assessed value of $447.5 million x .02247 = $10 million / 20,151 = $499), Fairfield remains a great bargain for the average lower-end homeowner who has children in the public schools.  Specifically, for a tax-deductible cost of **~$8,900** ($8,400 + $500), that homeowner receives in return ~$4,300 worth of municipal services (total municipal budget of $117 million minus commercial, industrial and personal property taxes of ~$31m = $86m / 20,000 = $4,300) and ~$14,000 in education services per child in school.  Two children in school results in total value received of **~$32,000** at an after-tax cost of less than $8,000 (e.g., a $8,900 deduction at a 15% marginal tax rate = $7,565), resulting in a cost-benefit ratio of >1:4.  In other words, for an average lower-end homeowner with two kids in public schools, ~$23,000 of the $28,000 annual cost of educating his/her children is being paid by someone else.  At the other extreme, the owners of the property with the highest assessment in town ($23.3m, which implies a MV of $33.1m) are paying $521,304 per year in taxes (not including vehicle taxes), which after deducting $4,300 for municipal services, means that they are single-handedly paying the full cost of educating almost 40 of their neighbors’ children.

For many years, rich people happily improved, renovated and expanded their high-end homes, beguiled by what seemed to be an inexorable rise in real estate values, and confident in their belief (and their vanity) that their homes were worth as much or more than what the town’s tax assessor said they were worth.  It was supposed to be only a matter of time before they would harvest the substantial equity in their homes (representing for most of them a significant part of their total retirement assets), downsize from their expensive empty nests, and move somewhere with a pleasant climate and low taxes (property, income and estate).

Unfortunately, most of them did not consider what the effect on high-end real estate values would be when millions of other fortunate members of the Post-War Baby Boom tried to execute the same retirement strategy (a.k.a., head for the exit) at the same time.  As a result, the supply of high-end homes currently vastly exceeds the demand for them, and thus, at a time when market prices have firmed at the low end of the market (the combination of lower prices and historically low mortgage rates for qualified buyers has made it cheaper to own than to rent a home in many communities), prices on high-end real estate continue to decline.  Many, many examples can be found in Fairfield of high-end properties that have been unable to find buyers for several years even though the asking prices have been cut sharply, in some cases by more than half.

This situation is not going to change any time soon because every year there are more PWBB retirees who would like to sell (in the aggregate, 10,000 people will retire every single day in America for the next 20 years), and thus it is only a matter of time before more and more high-end home owners capitulate and sell their homes for substantially less than anyone, including the tax assessor, would have dreamed possible just a few years ago.  Adding to the scarcity of buyers in Fairfield will be the continued rise in other taxes in the State of Connecticut.  Lower market values will drive further reductions in tax assessments on higher-end properties in coming years.  The tax assessor’s Residential Grand List will continue to shrink, even though the value of low-end real estate, because of appealing affordability, is likely to show modest gains.  The gap between the taxes paid on the average home and the taxes paid on the median home will contract.

When new budgets must be approved each year by various town boards, it is now customary to hear from many parents with school-age children arguing in favor of higher rather than lower spending on education.  Of course, most of the people doing so (and often invoking such slogans as, “The Children are Our Future,” “Quality of Schools is Important to Property Values,” and “People Come Here Because of the Schools”), are among those who are paying only a small fraction of the cost of educating their own children (once again: 95% of Fairfield homeowners pay on average $8,900 in property and vehicle taxes, receive $4,300 in municipal services, and therefore contribute only $4,600 to support an education system that spends over $14,000 per student).  With ~10,000 students in its public schools and ~20,000 residential property owners, at most 50% of Fairfield homeowners have children in the public schools.  If on average there are two children per “public-school home,” then only 25% of Fairfield homeowners have children in the public schools.

Many people do indeed move to Fairfield because they can obtain a high-quality education for their children, particularly because they don’t have to pay the full cost of it.  This great bargain does indeed support property values at the lower end of the market (again, that wonderful >1:4 cost-benefit ratio for the average lower-end homeowner).[4][4]  However, others are being forced out, including those in lower-end homes who do not have children in school, and those in higher-end homes who can no longer afford to pay high taxes.  People in both categories do not have to live in communities like Fairfield where they are required to heavily subsidize the educations of their neighbors’ children.  They can move to communities that are more homogenous and/or have relatively few school-age children (preferably in states that do not have high taxes because they do not have large urban centers filled with people who are dependent on government aid), where they can live well at a substantially lower cost in terms of property taxes.

“Moving on” is precisely what people will be doing in increasing numbers in the future as fewer and fewer people who do not have children in public school choose to live in Fairfield.  As they do so, the supply of high-end homes will continue to exceed demand for those homes, and thus their prices will fall.  In addition, some of the large estate properties that have become unaffordable will be sold to developers who will subdivide them and put multiple homes where there was previously only one, and the buyers of these new homes will also be much more likely to send their children to Fairfield’s fine public schools than to private schools.

As the prices of higher-end homes fall and work their way into the tax assessor’s valuations, the tax burden will become less skewed and more balanced, which simply means that property taxes for lower-end homes will increase inexorably at the same time that property taxes for high-end homes (because they were once believed to be even higher-end homes) will not increase and may even decline.

If between 2010 and 2014 (when the next revaluation takes place), the value of higher-end homes declines by 33% while all other residential properties (i.e., those with market values <$1.5m) maintain their value, then the R.G.L. would decline by 6.2% from $9.03 billion to $8.47 billion, and *ceteris paribus* (i.e., assuming no change in the value of all other property in Fairfield – commercial, industrial, motor vehicles and personal property – and assuming no net new residential construction) the mill rate would have to rise 5.4% from 22.47 to 23.68 to collect the same ~$245 million in total property taxes.   The resulting shift in tax burden from higher-end to lower-end homeowners in Fairfield would add 1%-2% per annum to lower-end homeowner taxes over that four-year period.  Since, even if it is carefully controlled, the town's budget will rise 3%-4% per year (due to such factors as the cost of funding post-retirement benefits and continued growth in school enrollments), this incremental 1%-2% from The Great Compression would result in total tax increases of ~5% annually on lower-end residential properties.

Meanwhile, as noted above, The Great Compression in real estate values will be accompanied by a pronounced demographic shift toward more families with children in the public schools, which means that the number of students in Fairfield schools will continue to increase faster than anyone currently expects.  As a consequence, the annual increases in the town’s budget are likely to exceed the 3%-4% rate that most people currently expect.  There will also be a need to add more and more classrooms, which means more capital spending and more future debt service.

In conclusion, the four major policy implications of The Great Compression are as follows.  First, because of the upward pressure on the taxes of lower-end homeowners, there will be substantial, unremitting pressure on town officials and boards to hold the line on both educational and municipal costs.  Second, there will be continued upward pressure on education costs from continued higher-than-expected growth in school enrollments.  Third, towns like Fairfield will be desperately seeking commercial and industrial development to ease the tax burden on residential homeowners.[5][5]  Fourth, an increase in commercial and industrial development will change the character of many communities, which in turn will lead to other pressures.

[1][1] Based on the most recent data, in the 2007-2008 school year, Fairfield spent $30.8 million on 1,045 Special Ed students (10.5% of total students), or almost $30,000 per pupil, and it spent ~$12,500 per pupil on all the other students.  Fairfield’s overall spending per student that year was 14% higher than its District Reference Group (i.e., schools in similar CT towns).  These numbers do not include spending on land, buildings or debt service, in which category Fairfield’s spending per pupil was 69% higher than its DRG.  Applying the 2007-2008 data to the current budget, Fairfield would save ~$18 million (7% of its total budget and 12% of its education budget) if it spent the DRG average per pupil.

[2][2] Down 12% from $10.3 billion the previous year, even after adding in the value of new construction.

[3][3] This total is understated to the extent that some higher-end properties are composed of separate pieces, not all of which are valued above the $1.5m MV threshold that I used to identify them

[4][4] The break-even home market value for a family with two children in school (and therefore receiving $28,000 in annual education benefits plus $4,300 in municipal services) is ~$2.75 million based on what they pay in property taxes (assuming they are in 25% tax bracket: $28,000 + $4,300 = $32,400 = 75% of $43,200 = 2.247% of ~$1.9 million = 70% of ~$2.75 million).

[5][5] If higher-end real estate is down 33% at the time of the next revaluation in 2014, the increase in the assessed value of commercial, industrial and personal property that would be required to offset that decline is ~40% ($562m / $1,388m = 40.5%).