CATEGORICAL EXEMPTIONS FROM THE REAL ESTATE TAX: AN EXAMINATION OF LOCAL EFFECT

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This paper examines the costs and policy implications of categorical exemptions from the real estate tax. These implications are examined through analysis of demographics of several counties in the State of Indiana and the impact of categorical exemptions on the taxable base of each county. The paper advocates for the use of tax expenditure analysis for the real estate tax to provide transparency and accountability and to inform decision-making, and offers consideration of formalized payments in lieu of taxes as an alternative to statutory modification.

INTRODUCTION

The Real Estate Tax ("RET") has long been, and continues to be, the backbone of municipal budgets, funding basic local services like fire and police protection, as well as infrastructure (referred to in this paper as "Services and Infrastructure"). Most states provide categorical exemption from the RET for "charitable" organizations and other entities generally qualifying for exemption from the Federal Income Tax ("FIT"), as well as for governmental entities ("Exempt Entities" or "Categorical Exemptions").

This paper will address the local cost of Categorical Exemptions. Measuring the local cost of Categorical Exemptions becomes especially relevant as local budgetary constraints become greater. In most states, the RET has been limited by either constitutional or statutory means, commonly referred to Tax Expenditure Limitations ("TELs"). Many municipalities have suffered economic hardship because of these limits, and they operate to remove local control from local budget issues that directly affect quality of life in a community. Further, poorer communities are more prone to suffer degradation of Services and Infrastructure from TELs than wealthier communities, causing the marginal utility of potential revenues lost to Categorical Exemptions to be higher for poorer communities. National estimates of the cost of Categorical Exemptions are around five percent. However, the impact on a given community is what matters most to its residents, and the local cost of Categorical Exemptions can vary notably highly aggregated estimates. This is the reason for examination of local cost. This paper advocates the use of Tax Expenditure Budgets ("TEBs") that include holistic and consistent Categorical Exemptions, to understand the costs associated with these exemptions. TEBs can operate as a useful tool to provide greater transparency and accountability to inform decision-makers.

This paper does not advocate for elimination of Categorical Exemptions, nor does it imply that Exempt Entities are not worthy of support. Rather, it argues that responsible governance demands transparent information regarding the costs of tax benefits so that informed decision-making occurs. Certainly, Exempt Entities provide benefits to communities. However, measurement of such benefits is beyond the scope of this paper, and it falls to each such entity to advocate for itself to those from whom it seeks support. The focus of the paper is to emphasize that, since the RET is dependent on local demographics, policy determinations should be made based on a cost-benefit analysis that includes local costs. Further, Exempt Entities may be reducing RET revenues from one budget, while providing services that would be funded from a different budget if the government were providing the same service. This represents a lack of

nexus. Data should be available so that taxpayers and legislators can decide if any lack of nexus is important to them.

These implications are examined and analyzed by first describing the RET, including Indiana Categorical Exemptions. Second, analysis and comparison of calculated costs of Categorical Exemptions are made among counties. Third, policy and other practical considerations related to categorical exemptions are discussed, including distinguishing the appropriateness of such exemptions in the context of the FIT versus the RET. Finally, proposed actions are offered to address perceived policy inconsistencies and the need for relevant data to provide ongoing awareness and analysis.

THE REAL ESTATE TAX

Structure of the Tax

The RET is a state ad valorem tax levied on a net value of real estate calculated in accordance with each state's statutory definition. Every state exempts certain real estate from taxation, usually based on ownership or on use (Kenyon and Langley, 2011; Montana Revenue and Transportation Interim Committee, 2011; Siegel and Metcalf, 2000). Most RET statutory schemes also contain deductions, credits, and other mechanics that reduce the net taxable value of the real estate. However, reductions in the taxable base other than constitutional and statutory Categorical Exemptions are beyond the scope of this paper. The RET structure in the State of Indiana is typical of most states (Dornfest, VanSant and Anderson, 2013; Kenyon and Langley, 2011; Siegel and Metcalf, 2000), and will be discussed particularly in this paper to provide consistency, as an examination of selected Indiana counties is considered.

There are three main moving parts in the RET, as follows: the value of the real estate, the amount of the budget, and the rate calculated every year to fund the budget. Most taxes apply a statutory rate against a flexible taxable base to calculate the tax (Montana Revenue and Transportation Interim Committee, 2011; Siebert and Metcalf, 2000). For example, the income tax applies statutory rates against taxable income. The statutory rates remain generally fixed from year to year, and the base (taxable income) varies from year to year. The sales tax operates similarly, applying a statutory rate against a variable base (the amount of the sale). The RET works in the opposite. First, the local government of the taxing jurisdiction develops a budget. Then, the local government derives a rate by dividing the budget by the total taxable value of parcels located in the jurisdiction. Since there is a finite number of parcels of real estate in any taxing jurisdiction, there is a direct cause-and-effect relationship between exemption from the RET and the associated increase of the RET rate applied to remaining, non-exempt parcels. The cost to taxpayers of Categorical Exemptions from the RET is more direct than for any other tax.

Expenditure of RET Dollars

According to the Indiana Department of Local Government Finance ("IDLGF"), every dollar of RET revenue is spent approximately as follows: $.41 for K-12 schools, $.19 to run cities and towns, $.17 to run counties, $.08 for TIF districts, $.07 for special districts, $.04 for libraries, and $.03 for costs of running the various townships (IDLGF). The various counties use these

allocations to pay county salaries and other costs. This includes wages for employees who work in the county jails and sheriffs' offices, in the prosecutors' offices, as well as public defenders. County employees also work in the auditors' offices, assessors' offices, recorders' offices, treasurers' offices, coroners' offices, in voter registration, and surveyors' offices. County employees also work to maintain buildings, highways, parks, and group homes. Public health officers are also on the payroll, as well as a host of individuals who work for the county courts. Capital development projects, bond maintenance, bridge maintenance, health initiatives, and parks and recreation are also funded from RET revenues (Vigo 2016 Budget).

Tax Expenditure Limitations: The Budgetary Girdle

TELs are a tool to try to control the cost of local government. They are state statutory or constitutional provisions that limit revenues or expenditures of a state or local government, and represent a continuation of an ongoing struggle for autonomy between states and local municipal jurisdictions (Teaford, 1973). The notoriety of California's Proposition 13 in 1978, followed by Massachusetts' Proposition 2-1/2 in 1980, served to kick off the most recent trend in TELs in the United States. Today, most states have enacted some form of TEL (Dornfest et al., 2013). Mullins and Wallin (2004) note seven different forms of TELs, as follows: (1) overall property tax rate limits applying to all local governments; (2) specific property tax rate limits applying to specific types of local government (municipalities, counties, school districts, and special districts) or specific functions; (3) property tax levy (revenue) limits; (4) general revenue limits; (5) general expenditure increase limits; (6) limits on assessment (base) increases; and (7) full disclosure (truth-in-taxation) requirements. Tax reformers advocate for TELs to reduce government spending and improve efficiency, but the law of unintended consequences has intervened.

In the wake of the passage of Proposition 2-1/2, research indicated that although taxpayers sought to reduce taxes and increase government efficiency by its passage, they did not intend or desire to reduce services funded by the capped taxes or to substitute other revenue sources (Ladd and Wilson, 1982). TELs have not achieved their intended ends. They have not stopped spending or reduced the size of government (Blom-Hansen, Baekgaard, and Serritzlew, 2014). Nevertheless, TELs have altered the structure of local finance, and one outcome has been to reduce local services, both in quantity and quality (Mullins, 2004). To add insult to injury, one proven effect of TELs is to provide a negative impact differential on communities that constitute the urban core of a local taxing jurisdiction, as well as economically disadvantaged communities (Mullins, 2004).

Since TELs reduce the ability of local government to generate revenues in a more self-sufficient way, another result has been to shift power from the local government to the state government (Mullins and Joyce, 1996). In periods of lesser fiscal restraint, municipalities would look to the state to make local funding allocations. However, in recent years, state governments have suffered severe economic stress, resulting in fewer resources (in the billions of dollars) available to make local funding allocations. This factor has exacerbated the impact of TELs on local governments (Mullins, 2004). State funding for school districts and local governments has been especially hard hit, and this phenomenon together with restrictions in local autonomy imposed by TELs has left local governments with few strategic alternatives than to create new revenue

sources (Blom-Hansen et al., 2014). These new sources are most usually in the form of fees and charges. Localities often must finance projects with debt, which decreases economic efficiency to the public.

The political effect is that needs of local residents are not as well served by state-level politicians as by local politicians, who are more directly accountable to the local population. Further, the piece-meal structure of fee-based "work-arounds" decreases transparency and accountability of the government, both of which are desirable attributes of good tax policy.

The impact of TELs on local government exacerbates policy inconsistencies due to lack of nexus presented by Categorical Exemptions. A locality that has had to tighten its fiscal belt will be less able to absorb the wasted revenues that these policy inconsistencies create. The marginal utility of Categorical Exemptions is higher in tight fiscal times, and for those communities for which TELs create a negative impact differential, the marginal utility of Categorical Exemptions is higher still. TELs operate as a *de facto* policy shift in funding local budgets from a RET base to other means.

Relationship of RET Rates and Wealth

Correlation and multiple regression analyses were conducted to examine the relationship between the RET rate in each of the 92 counties in Indiana and two measures of wealth as variables: the percentage of all people living in poverty and median household income. Table 1 summarizes the descriptive statistics and analysis results. As can be seen, both median household income and percentage of persons living in poverty positively and significantly correlate with the criterion. This indicates that those taxpayers living in counties with median household incomes lower than the state median or percentages of persons living in poverty greater than the state median tend to pay a rate of RET higher than the state median. Since the independent variables were economic variables that are by their nature correlative, Significance F was relied upon to determine whether the model was a good fit.

Multiple R	**0.4576**
R Square	**0.2094**
Adjusted R Square	**0.1916**
Standard Error	**0.4409**
Observations	**92**

	df	*SS*	*MS*	*F*	*Significance F*
Regression	**2.0000**	**4.5819**	**2.2910**	**11.7838**	**0.0000**
Residual	**90.0000**	**17.3030**	**0.1944**		
Total	**91.0000**	**21.8850**			

Table 1

Descriptive Statistics of Relationship Between Rate of Indiana RET and Two Variables

	Coefficients	*Std Error*	*tStat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	**-0.9431**	**0.6929**	**-1.3612**	**0.1769**	**-2.3199**	**0.4336**
Med Hhld Inc	**0.0000**	**0.0000**	**3.1706**	**0.0021**	**0.0000**	**0.0000**
% Poverty	**0.0999**	**0.0210**	**4.7671**	**0.0000**	**0.0583**	**0.1416**

A number count of counties was performed to determine how many that paid a median rate of RET higher than the state median rate also possessed a percentage of all persons living in poverty above the state median. Seventy of the 92 Indiana counties (76.1%) did, and 22 (23.9%) did not. A number count of counties was also performed to determine how many that paid a median rate of RET higher than the state median rate also had median household income lower than the state median household income. Fifty of the 92 Indiana counties (54.3%) did, and 42 (45.7%) did not. When the two variables were combined, 18 counties (19.6%) were negatively correlated to both variables, 47 counties (51.0%) were positively correlated to both variables, 23 counties (25.0%) were positively correlated to the percentage of all persons living in poverty variable and negatively correlated to the median household income variable, and 4 counties (4.4%) were positively correlated to the median household income and negatively correlated to the percentage of all persons living in poverty variable.

Categorical Exemptions in the State of Indiana

Most states utilize federal Internal Revenue Code ("IRC") Section 501(c) exemption categories to define exemptions from various state taxes, including the income tax, sales tax, and the RET. These "piggy-back" exemption categories either define Categorical Exemptions by direct reference to IRC Section 501(c) or by each state's own articulation of entity attributes, which usually closely approximate IRC Section 501(c) attributes (Dornfest et al., 2013; Siebert and Metcalf, 2000). Therefore, even if a given state independently considers and makes a determination regarding an entity's "charitable" nature to determine exemption, for purposes of discussion this paper uses the criteria used by the Internal Revenue Service to grant qualification under IRC Section 501(c). It is comparable because the policy discussions in this paper focus on the relationship between a RET exemption and an organization's charitable status generally, and not on the fine distinctions in what causes an organization to qualify or not qualify in a given jurisdiction. State court considerations of whether an organization is "charitable" tend to focus on the actual activities undertaken by the organization, and whether these activities meet the particular state's definition of "charitable."

State courts tend to utilize a quid pro quo rationale (Calhoun, 2011; Brody, 2010). The compliance analysis in cases that consider whether to revoke IRC Section 501(c) status focuses on whether actual activities of the otherwise exempt organization are consistent with the stated purposes of its organization, which were the purposes set forth in the organization's application for exemption. These organizational stated purposes are set forth in an organization's charter (articles of incorporation or similar documents) and the Internal Revenue Service scrutinizes this information in its determination of whether to grant tax-exempt status under IRC Section 501(c).

Challenges to an entity's FIT exemption can be based on an inconsistency between the stated charitable purpose and the activities of the entity. Even substantial unrelated commercial activities will not taint FIT tax-exempt status as long as the revenues from the unrelated activity are used for the charitable purposes of the organization (Brody, 2010; Bowman, 2003). States are more prone to view unrelated business activities as tainting RET exempt status (Brody, 2010).

Table 2

Indiana Categorical Exemptions from the Real Estate Tax

Categorical Exemption (IC 6-1.1-10 et seq.)
Real estate owned by the U.S. government
Real estate owned by the State of Indiana, its agencies and political subdivisions (including certain leased property)
Real estate owned by Indiana cities and towns where the property is used to provide a municipal service, including schools, libraries, parks, golf courses, playgrounds, swimming pools, hospitals, waterworks, utilities, sewage treatment or disposal, cemeteries, auditoriums, or gymnasiums
Real estate owned by rural, non-profit sewage disposal organizations
Industrial waste control facilities not used in production of salable property
Airports
Real estate (land and buildings) owned, occupied, and used for educational, literary, scientific, religious, or charitable purposes (including parking lots)
Real estate owned by non-profit land and water preservation organizations
Residential real estate on which a residence will be built and given away to low income individuals to be used as a residence (Habitat for Humanity-type activities) for up to eight years
Child care facilities (both for-profit and non-profit) for children between the ages of four and six
Lakes and reservoirs used to generate hydroelectric power
Low income housing
Soldiers and sailors museums
Real estate owned by a non-profit corporation and operated to promote the fine arts
Real estate owned by churches or religious societies
Real estate owned by fraternal beneficiary associations (note that there is no requirement for federal tax exemption status)
Real estate owned by federal tax-exempt fraternities and sororities (including headquarters and administrative facilities, as well as "foundations" related to sororities and fraternities)
Real estate owned by the YMCA, The Salvation Army, The Knights of Columbus, The Young Men's Hebrew Association, the YWCA, Disabled American Veterans of WWI or II, Veterans of Foreign Wars, American Legion, American War Veterans, The Boy Scouts of America, The Girl Scouts of the USA
Real estate owned by a county of district agricultural association of the State of Indiana
County fairgrounds
Real estate used for a free clinic
Common areas in real estate developments
Small business incubators

While Indiana Categorical Exemptions will be discussed with particularity in this paper, the Categorical Exemptions defined by Indiana statutes is similar to those provided in most states (Montana Revenue and Transportation Interim Committee, 2011; Siebert and Metcalf, 2000). A summarized list is contained in Table 2.

OUTCOMES: AN EXAMINATION OF INDIANA COUNTIES

Ten percent of Indiana Counties were selected for examination to determine the cost of Categorical Exemptions to each county, and to discover any correlation between this cost and demographics of each county. Approximately 74 percent of Indiana counties pay a median RET rate below the state median RET rate, and selection of the first five counties was made so that each of five intervals below the zero differential was represented. Next, to compare counties with approximately the same differential above the state median RET rate, five counties were selected that approximated the same differential above the state median rate. There is a lack of consistency among Indiana counties in reporting Categorical Exemptions to the state (Indiana DLGF, 2016), and Categorical Exemptions are not included in annual governmental reports. Therefore, a criterion for selection was that the county also maintain data on Elevate GIS service, since these were available for download. The exception was Vigo County, which maintained information on Beacon GIS service, but which was otherwise available.

Demographics of Selected Counties

Tables 3 and 4 present U.S. Census data for the State of Indiana and selected counties (U.S. Census Bureau Quickfacts) in alphabetical order. Table 3 sets forth comparative data for counties paying a RET median rate higher than the state. Table 4 sets forth comparative data for counties paying a RET median rate lower than the state.

Categorical Exemptions: Predictability and Cost

Parcel records for the selected counties were downloaded and sorted based on parcel category. Table 5 sets forth, in descending order, the differential median RET rate for each selected county, as well as percentages of total gross assessed value allocable to Categorical Exemptions. State colleges and universities are presented in the non-government category, for two reasons. First, state colleges and universities are separate legal entities in the State of Indiana. Second, these entities are not protected constitutionally from taxation, as governmental units are.

Table 3

U.S. Census Demographics of Counties Paying RET Rates Above the State Median Rate

	State of Indiana	Cass County	Elkhart County	Grant County	Hendricks County	Vigo County
Population	6,666,818	37,994	205,032	66,491	163,685	107,517
Number of Housing Units	2,885,304	16,359	79,004	30,480	61,738	47,349
Percentage of Owner-Occupied Housing Units	68.7%	75.6%	68.7%	68.8%	79.3%	61.0%
Median Value of Owner-Occupied Housing Units	$126,500	$82,500	$125,300	$84,600	$165,200	$91,900
Persons per Household	2.55	2.56	2.80	2.40	2.75	2.42
Median Household Income	$50,433	$43,918	$49,692	$40,272	$73,042	$41,221
Per Capita Income	$26,117	$22,625	$22,387	$20,348	$31,335	$22,079
Percentage of Persons in Poverty	14.1%	12.5%	13.2%	20.3%	5.8%	17.8%

With the exception of Monroe County, counties possessing greater percentages of total Categorical Exemptions also paid median RET rates above the state median rate. However, the relationship between percentage of total Categorical Exemptions and median RET rate differential does not appear to be linear. Ignoring the outlier, Monroe County, a 21.25 percent differential was observed between Harrison County, which possesses the highest percentage of total Categorical Exemptions in the negative differential group, and Hendricks County, which possesses the lowest percentage of total Categorical Exemptions in the positive differential group.

Table 4

U.S. Census Demographics of Counties Paying RET Rates Below the State Median Rate

	State of Indiana	Benton County	Harrison County	Martin County	Monroe County	Morgan County
Population	6,666,818	8,613	39,898	10,215	146,986	69,713
Number of Housing Units	2,885,304	3,919	17,071	4,813	61,550	28,348
Percentage of Owner-Occupied Housing Units	68.7%	72.6%	81.0%	77.9%	54.3%	71.6%
Median Value of Owner-Occupied Housing Units	$126,500	$81,500	$133,400	$95,400	$161,300	$144,400
Persons per Household	2.55	2.53	2.69	2.39	2.37	2.68
Median Household Income	$50,433	$48,069	$52,926	$47,457	$43,389	$57,521
Per Capita Income	$26,117	$23,181	$25,319	$23,913	$25,488	$26,556
Percentage of Persons in Poverty	14.1%	11.5%	10.2%	12.4%	23.8%	10.5%

Table 5

Percentage of total gross assessed value of property owned by Exempt Entities

County	Government Exempt	Non-Government Exempt	Total Exempt	State Median Rate Differential
Elkhart	5.30%	5.33%	10.98%	+0.90
Hendricks	6.09%	2.24%	8.33%	+0.63
Cass	8.28%	1.98%	10.26%	+0.62
Grant	5.90%	12.84%	18.74%	+0.54
Vigo	2.70%	12.00%	14.70%	+0.33
Monroe	4.97%	18.45%	23.42%	-0.31
Martin	2.21%	2.66%	4.87%	-0.47
Morgan	1.77%	3.05%	4.82%	-0.58
Harrison	4.72%	2.15%	6.87%	-0.67
Benton	3.48%	1.69%	5.17%	-0.87

A similar relationship was observed with regard to government Categorical Exemptions and median RET rate differentials. Counties possessing the highest percentage of governmental Categorical Exemptions also paid median RET rates above the state median rate. There also appears to be no linearity between government Categorical Exemptions and differential median RET rates. Considering only governmental Categorical Exemptions, Monroe County ceases to be an outlier, and the differential between the 4.97 percent of gross assessed value in that county owned by governmental entities and the lowest percentage in the positive differential group (4.99 percent in Vigo County) is 0.4 percent.

When the relationship between non-government Categorical Exemptions is compared with differentials from the state median RET rate, there appears to be no predictable relationship. Counties with the four lowest percentages of non-government Categorical Exemptions (Benton at 1.69 percent, Cass at 1.98 percent, Harrison at 2.15 percent, and Hendricks at 2.24 percent) are equally represented in the positive and negative differential rate groups. These counties are also equally represented above and below the state median household income measure, with Benton and Cass counties having median household incomes below the state level and Harrison and Hendricks counties having median household incomes above the state level. However, each of these counties possesses a percentage of all persons living in poverty that is below the state percentage. With the exception of Monroe County, counties with the four highest percentages of non-government Categorical Exemptions (Monroe at 18.45 percent, Grant at 12.84 percent, Vigo at 9.70 percent, and Elkhart at 5.33 percent) fall within in the positive differential rate group. Monroe County possesses a negative differential rate. With the exception of Elkhart County, these counties are poorer than state measures. They all have median household incomes below the state median level, and all but Elkhart have percentages of persons living in poverty above the state measure. Elkhart County possesses 13.2 percent of persons living in poverty, as compared with the state measure of 14.1. Two outcomes in this group may merit future study. First, Elkhart County, which possesses the highest differential RET rate of +0.90, also has a rate of persons living in poverty below the state percentage but a median household income below the state median. Second, Monroe County pays a negative differential RET rate of -0.31, but also appears to be poorer than the state measures based on both percentage of persons living in poverty and median household income.

Median RET rates published by the state do not take into account only Categorical Exemptions, and do take into account many more deductions and credits in the tax structure. Therefore, to calculate the cost of Categorical Exemptions, a pseudo tax base (Pseudo Base), pseudo tax rate (Pseudo Rate), and pseudo tax (Pseudo Tax) was calculated for each County. First, Categorical Exemptions was subtracted from the gross assessed value of real estate to calculate the Pseudo Tax Base. The Pseudo Tax was calculated by multiplying the median rate by the Pseudo Tax Base. The Pseudo Tax was then divided back into the gross assessed value to calculate a Pseudo Rate. The Pseudo Rate is compared with the published median rate to determine the cost of Categorical Exemptions.

Table 6

Cost of Categorical Exemptions Expressed as Incremental Percentage of RET

County	Government Exempt	Non-Government Exempt	Total Exempt	State Median Rate Differential
Elkhart	**5.59%**	**5.63%**	**11.88%**	**+0.90**
Hendricks	**6.48%**	**3.51%**	**10.47%**	**+0.63**
Cass	**9.03%**	**2.02%**	**11.44%**	**+0.62**
Grant	**6.27%**	**14.73%**	**23.06%**	**+0.54**
Vigo	**2.78%**	**13.64%**	**17.23%**	**+0.33**
Monroe	**5.23%**	**22.63%**	**30.59%**	**-0.31**
Martin	**2.26%**	**2.73%**	**5.12%**	**-0.47**
Morgan	**1.80%**	**3.15%**	**5.06%**	**-0.58**
Harrison	**4.95%**	**2.20%**	**7.38%**	**-0.67**
Benton	**3.61%**	**1.71%**	**5.45%**	**-0.87**

Comparison of the cost of government Categorical Exemptions to the percentage of gross assessed value displaced by these exemptions disclosed variances ranging from 0.03 percent in Morgan County to 0.75 percent in Cass County. The mean of this differential was 0.38 percent in the positive differential group and 0.14 percent in the negative differential group, but there was no pattern as to which differential group the variances fell. However, the cost of governmental Categorical Exemptions exceeded the percentage of gross assessed value displaced by these exemptions in every case.

Further, as the cost increased, so did the variance. Comparison of the cost of non-governmental Categorical Exemptions to the percentage of gross assessed value displaced by these exemptions disclosed variances ranged from 0.02 percent in Benton County to 4.18 percent in Monroe County. The mean of this differential was 1.03 percent in the positive differential group and 0.88 percent in the negative differential group. Similar to government Categorical Exemptions, there was no pattern as to which differential group the variances fell. Also similar to governmental Categorical Exemptions, the cost of non-governmental Categorical Exemptions exceeded the percentage of gross assessed value displaced by these exemptions in every case. As cost increased, so did the variance.

POLICY CONSIDERATIONS

Equity

The concept of equity is a general consideration of the fairness of a given provision in the structure of the tax. In the context of tax policy, fairness relates to the distribution of wealth or the burden of taxation (JCT, 2008). Distribution of wealth is a consideration more prominent in discussions of the income tax, both because of the nature of services funded by the income tax, as well as by the mechanics of calculating the taxable base. In the context of the RET, since RET exemptions are not provided to potential taxpayers who replace services funded by the relevant budget, fairness relates to the burden of taxation.

Removing real estate is removed from the tax base through exemptions requires the remainder of the base to sustain a greater financial burden. Dissimilar treatment results where one property owner is exempt and another is not. Therefore, as a matter of policy, on its face, exemptions are not equitable. Further, if Exempt Entities provide services outside the taxing jurisdiction, this cost is borne by taxpayers without resulting benefit. Real estate tax exemptions also cause taxpayers with lower income levels to pay a higher percentage of their financial resources in tax. Since the RET uses a "flat" rate (determined generally by dividing the budget by the value of the base), it is a regressive tax when measured against income. Categorical Exemptions even treat Exempt Entities inequitably vis-à-vis one another. In many jurisdictions, only those who own property benefit.

Efficiency

In theory, efficient tax systems do not influence economic decisions. A perfectly efficient tax system supports the same decisions with the tax in place as would be made without it. When taxpayers make decisions that diminish performance of the economy, it is an inefficient use of resources. As applied to Categorical Exemptions, the exemption itself may induce Exempt Entities to remove real estate from the base, which does not advance societal goals that support the exemption. That is to say, the exemption encourages Exempt Entities to allocate surplus revenues to purchase real estate rather than to provide services (Daniel, 2006). Performance of the economy in terms of reduced Services and Infrastructure can be a direct result of the reduced tax base because of the impact of TELs. This inefficiency is directly attributable to Categorical Exemptions. Using debt as an alternative funding source is also an added inefficiency attributable to Categorical Exemptions.

Where the revenue constraint is fixed (as in the case of the local municipal budget), tax expenditures (in the form of Categorical Exemptions) requires a higher marginal rate to raise the same amount of funding. This is also a reduction of efficiency, called "deadweight loss" (JCT, 2008). These tax expenditures will amplify distortions.

Administration

Categorical Exemptions from the RET are associated with increased administrative costs, in both time and direct resources. Local governments are the decision-makers for applications for exemption as well as the point where challenges to exemption take place. Challenges to exempt status also use resources, especially where litigation results.

Federal Income Tax Exemption as a Comparator

History and Policy for Exemption. FIT exemption is discussed because most state RET Categorical Exemptions are tied to FIT exempt status, either directly or indirectly. Since the natures of the FIT and the RET are so dissimilar, there may be an established nexus between exempt entities for FIT purposes and a lack of such a nexus for the RET.

After the Sixteenth Amendment was passed, the Revenue Act of 1913 created the modern FIT system (Act of Oct. 3, 1913). FIT exemption for certain organizations pre-dates the modern

federal income tax system (Bittker, 1976). It includes charitable (schools, colleges, and similar organizations), religious, mutual benefit (consumer cooperatives, labor unions, trade associations, and fraternal organizations), and other nonprofit organizations (IRC Section 501(c)). The role of these Exempt Entities in the social structure of a young government was to fill a gap in providing social and welfare services that the government could not. Financial and other support provided to Exempt Entities by donors operated as a voluntary, *de facto* additional tax because the services provided by these Exempt Entities supplemented the same types of social and welfare services that were appropriate for a government to provide (Bittker, 1976).

Even as the tax law and the government matured, it was simply assumed that charitable organizations warranted continued exemption. The legislative history is scant in articulating precise policy justification for this. What there is leads one to the conclusion that in large part, support for exemption under IRC Section 501(c) is somewhat visceral; these organizations "do good" and "should" therefore be exempt. This policy position has been borne out in some language of courts in interpreting whether or not a given entity qualifies for the exemption (Bob Jones, 1983). There has also been debate about whether the lack of commercial focus is really the policy basis for exemption, based in early language in the tax law that some believe implies commercial intent as the basis for income taxation.

The fact that many FIT exempt organizations typically spend all of their revenues annually to fund services also contributes in support of FIT exemption. If charities spent all their donations annually in providing services, there would be no net income to tax. There was evidence early in the life of the tax law that charities simply generated too little tax revenue to bother. This perspective lacks substance as a policy argument (although it does support efficiency), and does not necessarily hold true in today's world of large, wealthy tax exempt hospitals and other wealthy "charities." The income tax would only apply to a charity's accumulation of revenue, since charities with no endowments usually spend most all of their program revenues on an annual basis. Despite little articulation of policy justification in the federal legislative history, the fact that certain organizations are exempt for FIT purposes is well established.

Evolution of Carve-Outs to Support Policy Nexus. Eventually, certain "carve-outs" in FIT exemption evolved. That is to say, Congress determined to tax certain economic activities not consistent with exemption.

In 1950, Congress added the unrelated business income tax ("UBIT") to the Internal Revenue Code. The UBIT rules taxed earned income of IRC Section 501(c) Exempt Entities to the extent that such income that was unrelated to their exempt mission. The Tax Reform Act of 1969 established an excise tax on the net investment income of private foundations to "share some of the burden of paying the cost of government" (JCS, 1970). In 1975, Congress decided to tax unspent income of political organizations.

The charitable contribution deduction allowed under IRC Section 170 also exemplifies federal differentiation of activities of IRC Section 501(c) exempt organizations. The charitable contribution deduction for individuals contributing to operating foundations is greater than that for non-operating foundations. Operating foundations run programs similar to those run by public charities. Non-operating foundations are primarily grant-making organizations.

The RET Distinguished

The RET carries a very different policy impact from the FIT. The differences in the basic structure of the RET and the purposes for which RET revenues are spent can exhibit a lack of policy nexus to exemption. There is even less recorded justification for many Categorical Exemptions in state legislative histories than in the federal legislative history (which is itself scant). In many cases, exemption is simply directly or indirectly tacked to FIT exemption, so there is little evidence in many cases that there has been a consideration of policy, other than a desire to support organizations that "do good." The contemporary environment entertains more controversy concerning Categorical Exemptions than existed in the past (Daniel, 2006).

The structure of the RET is based on the value of real estate owned, and not an incremental wealth measurement (taxable income) like the FIT. The RET is comparable to other operating costs, like utility costs, which have been estimated to equate to between 1.3 and 2.1 percent of annual revenue for non-church, non-governmental Exempt Entities (Cordes, Gantz and Pollack, 2002). Categorical Exemptions have a more direct effect of eroding the tax base for the RET than for the FIT because of the differences in the defined taxable base. Exempting certain organizations from paying their own operating costs directly reduces the funding ability of the local taxing jurisdiction. This, in turn, translates into decreased capacity to fund Services and Infrastructure. Because the exemption can result in reduced Services and Infrastructure to the rest of the community, the question is whether there is incremental harm or benefit in allowing exemption. The failure of Categorical Exemptions to address increasing commercial activities undertaken by Exempt Entities exacerbates this effect (Daniel, 2006).

Not only is the RET base directly eroded by Exempt Entities, the erosion occurs with little gatekeeping. Many jurisdictions simply accept a federal Determination Letter as the document used to support exemption from the RET. The Determination Letter is the letter issued by the Internal Revenue Service upon its determination that an entity satisfies the criteria of IRC Section 501(c) and is therefore exempt from FIT. In many jurisdictions, the Determination Letter is accepted by local jurisdictions to determine exempt status for RET purposes. This can mean a grant of exemption based on criteria and for purposes that have little or no policy nexus to the RET. Such broad-brush grants serve ease of administration, but little else. Since there is no limit or screening process on how many parcels Exempt Entities may own, one way to help ensure their value to local residents would be to test it through the market. In other words, if there is support through donative revenues (which are deductible for FIT and usually state income tax), the entity will have sufficient funds to pay their fair share of RET. Several jurisdictions have become more conservative through interpretations of ambiguous language in their exemption laws to limit exemptions to entities traditionally considered exempt (Youngman, 2002; Kenyon and Langley, 2011).

The purposes supported by the federal budget are also very different from municipal budgets. The federal budget is more welfare-oriented than local budgets. The federal budget funds items that the activities of charities and other exempt organizations would supplement, because of the nature of their activities. By comparison, RET revenues fund local needs that the activities of most charities do not supplement. This is not to say that Exempt Entities do not do good work;

just that the work being done is not typically of a nature to be funded otherwise by local government, thereby demonstrating a lack of policy nexus for RET exemption. There are, of course, exceptions. For example, distinguish school districts from colleges and universities: both exist for and serve educational purposes and would both qualify for exemption from FIT, but local budgets do not typically fund higher education (a policy disconnect where colleges and universities are Exempt Entities). Local budgets only typically fund K-12 school districts. The macro perspective (at the federal level) of exemption looks very different from the micro perspective (at the local level), and even if the taxes were structured similarly (which they are not) the budgetary link is not the same for both.

Tax Expenditure Analysis

Effective policy consideration and discussion requires appropriate data. Legislators need intelligible, comparative data to make informed decisions and take informed actions. Voters need the same so they can determine whether legislators are making decisions voters can support. Exemptions that are over-broad or that lack an appropriate cause-and-effect relationship represent no policy at all (Daniel, 2006), and data is the only tool that can assist in wading through these issues.

The concept of "tax expenditures" identifies and monetizes deductions, credits, exclusions, exemptions, and other tax preferences. Analysis of tax expenditures recognizes that many tax expenditures resemble direct governmental spending, and seeks to promote tax policy analysis and discussion by providing parity between direct budgetary expenditures and indirect tax expenditures. TEBs reduce direct and indirect expenditures to a line-item equivalent so that information regarding the costs of tax expenditures is available (Bell and Brunori, 2014). The tax system is simply an alternative funding source.

The concept of viewing deductions, credits, exemptions, and other tax preferences as part of the holistic budget of a taxing jurisdiction began in the 1960's in the context of the FIT, and became a requirement for the federal budget in 1974. One of the primary criticisms of Tax Expenditure Budgets (TEBs) in the context of the FIT is that specially treated items that would be labeled "tax expenditures" is derived by identifying items that deviate from the "normal" tax code, the definition of which is anything but consensual. Due to the inherent differences between an income tax and the RET, utilizing a TEB for ongoing tax policy analysis and discussion of RET tax expenditures would be a relatively straightforward proposition. The base for RET purposes is much less amorphous than for the FIT, which seeks to tax some definition of annual wealth increment (taxable income). Tax expenditure can be especially helpful for RET policy considerations because by nature the RET utilizes a consistent framework: the value of real estate within a given taxing jurisdiction that is determined relatively infrequently. Gross assessed values of real estate should be the starting point for RET expenditure analysis for two reasons. First, every jurisdiction assesses gross values as a starting point. The information is available. Second, starting with gross assessed value provides the most information, and therefore transparency.

Using gross assessed value of real estate as the starting point for a TEB allows measurement and analysis of all decreases of the tax base. Because Categorical Exemptions may not be included in

data reported about the RET, it can be inferred that state government may not view Categorical Exemptions as particularly relevant. In fact, Indiana's 2016 report on the real estate tax specifically notes that reporting of governmental exemptions is not consistent from county to county and discourages reporting of these amounts. Not tracking and reporting this data can result in obfuscation. For example, because real estate owned by state colleges and universities are commingled with other state-owned real estate in Indiana, data concerning this ownership is not readily available in summary form. In Indiana, state colleges and universities are separate legal entities from the state itself. Constitutional prohibitions against taxation of the government do not apply to state colleges and universities.

This is not to say that Exempt Entities do not provide benefits. Exempt Entities also provide economic benefits. These benefits include providing jobs and needed services in a community. The point is to recognize and understand the costs of exemption, and not to ignore these costs. Many larger Exempt Entities prepare economic impact reports to articulate the benefits they provide. However, economic impact statements rarely include indirect costs, like erosion of the RET base. Including this cost in a TEB would serve to provide complete information to stakeholders and decision-makers, including taxpayers and legislators.

PILOTS

Consideration of these issues does not have to be an "all-or-nothing" proposition. Some Exempt Entities make gratuitous payments in lieu of taxes ("PILOTs"). Although no state property taxing jurisdiction requires PILOTs, Federal housing law requires payment of PILOTs for certain qualified subsidized housing under 42 U.S.C. §1437(d), which can be reduced by state and local real estate taxing jurisdictions. This article uses the term PILOTs loosely to generally describe payments made in lieu of RETs, where state exemption would otherwise not require the payment.

There is a trend for local taxing jurisdictions to look to Exempt Entities to pay their fair share of RETs to help alleviate budget shortfalls (Grimm, 1999). PILOTs are another way to bring equity to government budgets, as well as to serve as a way to address indirect intergovernmental budgetary supplements where it would be otherwise unconstitutional to tax a governmental entity. Use of PILOTs has grown in popularity over the last two decades, although it is difficult to measure the use of PILOTs with accuracy. Municipalities and states do not record or report PILOTS with any consistency. Surveys have provided some data about PILOTs, supplemented with other *ad hoc* information.

A 1998 study surveyed municipal finance directors of 73 large cities across the United States and reported only seven PILOTs in six states (Leland 2002). A 2011 survey of children and family services, elderly housing and services, community and economic development, and arts and culture organizations disclosed that nine percent of 358 respondents (approximately 32 respondents) made PILOTs (Salamon, Geller and Sokolowski, 2011). A 2012 study reported that 218 localities in 28 states received PILOTs (Langley, Kenyon and Bailin, 2012).

Use of PILOTs is more prominent in the Northeastern region of the United States, with the states of Massachusetts and Pennsylvania having the most reported use (Langley, Kenyon and Bailin,

2012). Seventy-five percent of PILOT revenue occurred in only ten localities, all in the Northeast (Langley et al., 2012). Some believe that greater use of PILOTs has a direct correlation to greater dependency on RET in the municipal tax base of these states. Also, the Northeast has a larger number of Exempt Entities (Langley et al., 2012). Educational institutions make the largest amount of PILOT payments, followed by hospitals (92 percent of revenue and 46 percent of organizations making PILOT payments) (Langley et al., 2012). The government can also make PILOTs and this does happen, albeit with less frequency than by IRC Section 501(c) organizations. The federal government makes some indirect PILOTs, as well. Low-income housing projects provided by public housing authorities that receive federal funding must be exempt from property taxes and the housing authorities must make PILOTs equal to ten percent of net shelter rents, or a lesser amount set by state statute or agreed to by the local governing body (42 U.S.C. §1437(d)). At this time, taxing jurisdictions have no statutory authority to require PILOTs. Cities that have implemented PILOT programs have done so as part of a negotiated, voluntary public-private cooperative effort to help ensure their communities can provide needed Services and Infrastructure.

CONCLUSIONS

Scrutiny of Categorical Exemptions from the RET has become more important because of the changing nature of local finance, impacted both by TELs and the decline of state revenues. It is an appropriate point in the maturation of state and local finance to view attributes of the RET system in a more holistic and sophisticated way. Tracking and monetizing these costs is especially important because the costs are not predictable otherwise. Tracking and monetizing them is the only way to know what they are. A policy wedge is created between Categorical Exemptions and the RET by the structure of the RET base and the nature of Services and Infrastructure funded by municipal budgets. Understanding these costs is especially important to poorer communities because of the increased marginal utility of lost revenues to those communities.

It is a legislative prerogative to define exemptions from the RET. To inform this discourse, transparency requires maintenance of TEBs that identify the indirect costs of these tax expenditures. Maintaining TEBs for RET purposes is a more straightforward matter than for the FIT, and should use the gross value of real estate within a jurisdiction as a baseline. While it may be politically impossible or undesirable for other reasons to modify Categorical Exemptions, PILOTs represent a partial measure that could relieve some of the burden created by tax expenditures. An approach that would serve the policy objective of equity and also recognize the utility that certain Exempt Entities bring to a community would be to establish PILOTs at a level that approximates use of services used by Exempt Entities. Since poorer communities suffer more from tax expenditures created from Categorical Exemptions, state governments would have more complete information to consider, for example, whether to supplement communities hardest hit by these inequities.

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