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City Finances and the Property Tax

by C. LOWELL HARRISS

MORE than a little truth can be found in the statement, "Man creates his own problems." A sad example can be found in our tax on real estate.

Any tax bringing large revenues will have unpleasant effects—and the property tax in some cities now exceeds $200 a year per capita. But this tax is really two. One, the tax on improvements, can be horrible; but the other, the tax on land, can be one of the best.

The total property tax is often over one-fourth of gross income from the property—or 30 to 35 percent when expressed on the same basis as a retail sales tax, as a percentage of the cost of occupancy excluding tax. When rates of tax are so high, and when differences in tax burdens are appreciable (e.g., from one location, type of property, or activity to another), the indirect results can be substantial. Today, they influence cities profoundly and are needlessly bad. The same amount of revenue could be raised with significantly different, and better (or less bad) results.

Progress will come from redesigning property taxation, not to reduce total yield (for needs seem too great), but to take account of the essential differences between land and structures.

This article by C. Lowell Harriss, Professor of Economics, Columbia University, and Economic Consultant of the Tax Foundation, Inc., was published in the November MGIC Newsletter. It is reprinted by permission of the Mortgage Guaranty Insurance Corporation.

Land Versus Buildings

Land cannot move. The quantity is fixed. Rarely will the amount in existence in an area be subject to more than tiny changes by actions under the control of man. The space will be there, regardless of almost anything governments do by taxation. This space commands prices which are often "high." To a large extent these prices result from investments by the general body of taxpayers—government provision of streets and schools and other facilities—and demands of a growing public. A tax on land, a heavy one, will not reduce the supply — a merit which no other tax can claim. And such a tax can recapture for public uses much of the annual rental value or worth of what the public itself, as distinguished from the landowner, has created.

Buildings and other improvements present a striking contrast. Taxes on buildings at today's rates produce

(Continued on Page 14)

City Finances

(Continued from Page 1)

several kinds of bad results and help to account for some of the deplorable features of our cities.

The property tax on structures hits well-constructed, high-quality, buildings far more heavily per unit of space than slums and "junk." What perversity! The tax on buildings creates an incentive against upgrading of quality, especially in those parts of older cities with most urgent needs and high tax rates. To say the least, such discouraging of private effort to raise quality serves no useful public purpose.

When the tax bill goes up because the owner has constructed a better building, he does not get correspondingly more or better governmental services. But his investment has advantages for others around. As compared with the old, decrepit, and low-tax property, the new, high-quality building will bring the general public positive and desirable "neighborhood benefits."

Wise public policy would encourage better structures. The present tax, however, favors buildings which produce bad neighborhood effects. The owner of dilapidated structures — of residential, commercial, and industrial slums — will be freer from economic pressure to replace with something better if his tax goes down because the building gets worse. Any individual or business wishing to shift to use of a higher quality structure must also pay more toward the costs of government — $1 more of taxes for each $3 (or even $2) of annual payment for better facilities.

Cities which urgently need to replace obsolete, decayed, degrading, buildings rely heavily on a tax which creates a substantial bias against replacement. Nobody "planned" to set up a tax system with such deleterious influence.

Taxes and Maintenance

The quality of space available for work and living will depend greatly upon the maintenance of the stock of older buildings. Undermaintenance forms one way by which an owner can reduce his net investment in a building, and eventually the tax. His actions in letting a building run down will affect others, the larger neighborhood. Deterioration of a minority of buildings can hurt a considerable area. Good maintenance can be combined with spending for improvements which have "spill over" benefits for the whole neighborhood.

The property tax adversely influences maintenance. The tax reduces the net return from the structures and thus the attractiveness of investing more in such properties. Tax dollars are not available to finance maintenance. And with or without good reason, the owner may fear that a "repair and maintenance" job having visible results will bring an assessment increase.

Effect on Price

The higher the price of housing, the smaller the quality and the lower the quality purchased. The tax on buildings adds to price and thus reduces the amount demanded. One bad effect is a hidden, or what economists call an "excess" burden. It deprives the consumer of more real benefit than the dollars paid to government. For example, the cost per cubic foot of construction often declines as the size of the house, apartment, office, or other unit increases. The tax on buildings, however, creates pressure for constructing smaller units and thus deprives the occupant of potential benefits for which government treasuries get no dollars.

Other Undesirable Effects

High tax rates on buildings re-enforce incentives for creating "islands" of relatively low tax rates. A few of the localities which make up most metropolitan areas have tax resources which are above average in relation to service obligations. With lower tax rates they can have above average quality of services, attracting still more investment.

Some communities use zoning power to exclude types of property associated with high governmental expense—the high-density housing which requires heavy school costs. Other parts of the metropolitan area however, must pay higher taxes; elements of a vicious circle gain strength.

"Lower" taxes in the fringes encourage dispersal and the development "far out" of activities (including housing) which "ought not" to be so distant. Each increase in tax rate near the center will reduce the value of the property and the tax base. Many buildings in the older section will have deteriorated but yet have some "useful" life and a potential of prolonged decline before replacement. Owners of land with obsolete buildings delay replacement, in part because the speculative holding of the land involves little out-of-pocket tax costs. The tax base tends to go down, aggravating the need for higher tax rates. Businesses become vulnerable to competition from outlying neighborhoods.

People who wish to escape the urban center must leapfrog over the "islands." Such land use imposes higher costs than if population were spread more in accord with factors free from the influence of tax on buildings. The disadvantages take the form of: (1), costs in time and money of traveling greater distances from home to work; (2), higher expense of supplying water, sewer, and utility services over the far larger area; and (3), reduction in economic and social benefits which concentration of population facilitates.

What Can Be Done?

The adverse nonrevenue effects of high tax rates on buildings are more serious and more pervasive than generally recognized. Can we reduce them? Yes. How? By cutting local expenditures? Not much prospect here. By greater use of other local revenue sources or funds from state taxes? Possibly. The hope in this line offers some basis for optimism — but not enough.

Another opportunity deserves a try —raising the tax on land and reducing the burden on structures. An old idea —and yet one whose merits grow with every increase in local tax bills. To produce the same total revenue, the rate on land might be three, or even more, times that on improvements. For most property owners the tax bill would not change appreciably. Those with the worst buildings, or with land vacant, would have to pay more. They would face pressure from the land tax to construct new buildings, knowing that the tax on new structures would be much lower than under the present system.

A tax increase on land would have important effects other than the revenue yield which would "finance" a big cut in the burden on buildings. The new purchaser of land would pay less in price per square foot. But he would pay more each year as tax. Such change would favor the person with less capital, without making financing harder for persons more amply supplied with cash (and borrowing power). A buyer could acquire a plot with smaller initial outlay and with lower annual financing charge interest plus amortization). Each year's tax payment to government on land would be higher.

More land would be offered for sale or for use in new ways. Higher tax on land would force some owners to put land to more effective use. A heavier tax on inefficiently used land would add inducement to put into effect a type of use which would bring more income. Speculative withholding of land from better use would become more obviously expensive. The usable supply of land would rise, leading to more efficient use of a community's space — and reducing "urban sprawl" along with substantial cut in the rate of tax on improvements.

The practical possibilities? Given the will and the determination, quite a bit could be achieved soon under some state constitutions. In other cases, more time would be needed for reasonably broad implementation.

One immediate step in many communities would be to raise assessments on land while reducing, relatively, those on buildings. Huge increases in land prices have by no means been fully reflected in assessments. Local taxes have not siphoned off for the financing of local government more than a fraction of the increases in land prices, increases resulting significantly from expenditures by local governments.

The National (Douglas) Commission on Urban Problems estimated that in the decade to 1966 land prices in this country rose by around $240 billion. An annual average increase of $25 billion in a period when both tax and interest rates were rising testifies to powerful underlying forces raising land prices. A special tax on increments as such, often recommended, is not what is proposed here. But high and rising land prices do provide a base for collecting more local tax revenue based on land values in order to permit a desperately needed reduction in the tax on new and good buildings.

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A Westport, Massachusetts reader, Robert Harding Zwicker, reminds us that the 1969 William Allen White Award was recently given to radio and TV commentator, Walter Cronkite. No doubt many have forgotten that the publisher of the Emporia Gazette was interested in Henry George. Said Mr. White: "I believe Henry George started more men to thinking seriously and competently about public problems, and particularly problems of taxation, than any other American in one hundred years."