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AN ECONOMIST LOOKS AT PROPERTY TAX

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An Economist Looks at The Property Tax

C. Lowell Harriss

Dr. Harriss is Professor of Economics at Columbia University and an economic consultant for the Tax Foundation, Inc. He received his Ph.D. from Columbia and has been a member of that university's economics department since 1938. Dr. Harriss has also served as a consultant to numerous governmental agencies, including the U.S. Treasury; City and State of New York; Federal District of Venezuela; Committee on Federal Tax Policy; National Bureau of Economic Research; and Agency for International Development. He has also written a number of books and articles on economic theory, taxation and public finance, including "Gift Taxation in the United States"; "The American Economy" and "Money and Banking".

"The best of taxes, the worst of taxes." True, or very nearly so. Why such extremes? Partly because tens of thousands of separate jurisdictions impose the tax, with widely different qualities of assessment and even of basic laws. An even more important reason, however, lies in the economic difference between a tax on land and one on other forms of property.

Property taxation will be a candidate for the best as a tax on land in communities with good assessment. The worst effects come from the tax on reproducible property (intangibles included) where rates are high and administration poor. This paper will be confined to the tax as levied on real property—or, more accurately, to the two taxes.

The property tax in some cities and suburbs now collects each year more than $200 per capita ($1,000 for a family of five)—con-

siderably more in some places. Any tax that brings in large revenues will have substantial non-revenue effects. Behavior will change, and not just because people have less to spend and save. Because of the tax, individuals and businesses alter the way they carry on their affairs. When rates of tax are *high,* and when *differences* in tax burdens are very great indeed (e.g., from one area, type of property, or activity to another), the non-revenue results can be substantial. Results of the property tax today influence American life profoundly, and they are needlessly bad. The same revenue could be raised with much better results.

High Effective Rates

Although property tax rates when expressed as percentages are usually small numbers, they *apply to capital values* and are "high" and rising. Comparison with rates of income or sales taxes will often be deceiving. For example, a three percent property tax equals 33 percent of the pre-tax net income—and 50 percent of that after tax—from a property which yields six percent to the owner. An increase of one half a percentage point would reduce the amount remaining after tax in such a case by about eight percent. As a burden on housing the tax frequently exceeds 25 percent when expressed on the same basis as a retail sales tax.

Non-revenue results ought to command much more attention than in the past when rates were lower. In much of urban America today the effective tax rate approaches or exceeds three percent of full value and trends upward. New importance attaches to the tax and to the quality of its administration.

Moreover, changes in federal income taxation embodied in the Tax Reform Act of 1969 as passed by the House would greatly modify treatment of depreciation on real property. The "tax shelters" which have influenced investment in real estate in the last 15 years would lose much of their protective power. The relative importance of property taxation will grow if such income tax changes become law.

The property tax depends heavily upon judgment, as contrasted with income and sales taxes which are tied to market transactions. The wage agreement between employer and employee results in a payment upon which tax is then payable. The amount of sales tax follows from the price at which buyer and seller conclude a transaction. Income tax withholding and retailer collection of sales tax do even more to make these taxes incidental and almost automatic outcomes of market transactions.

Property tax, however, rests upon someone's estimate of the worth of property (and at times even his identification of the existence of the property). The range of what is possibly acceptable can be substantial. There is little that is self correcting, and the best reliance upon objective evidence can leave a rather wide area of uncertainty. The actual tax, therefore, can differ significantly according to the judgment of the assessor. The quality of administration relies heavily indeed upon the capacity, training, energy, and integrity of staff and the adequacy of the facilities provided.

Merits and Strengths

Any tax collecting $150 or more a year per capita as a national average will have undesirable non-revenue and side effects. Before dealing with some of those arising from property taxation, let me comment on strengths, especially as the tax is applied where the leaders of this profession dominate the administration.

1. *Viability of Local Government.* The tax now finances local government, not fully and not to the same relative extent as in the past, but enough to make local government meaningful and viable. Heaven forbid romanticizing the virtues of "government close to the people," of home rule, or the real life operations of local government. All of us have read about weaknesses of local government, and more than one person in this room has seen much to which he will not point with pride. Anything humans do must be affected by the fallibility of men—and even women. State and national government are also less than perfect; so is the world of business and even, we hear, of non-profit organizations.

Be reality as it may, the use of localities to get some of the things we expect from collective (governmental, political) action has great merit. Having recently visited many countries, I have become increasingly convinced that we are fortunate to have as much decentralization, as contrasted with centralization, of government as we do. Property taxation offers people in different localities a way by which they can make some significant, truly local choices. Local sales and income taxes, fees and charges also aid financial independence, much more so than in the past. Property taxation stands out, however.

2. *Benefit.* A significant *benefit* basis exists, especially that

related to paying for different quantities of services in one community as compared to another. Here there is an element of justice. Within communities the relation of benefits received to tax paid will often be crude and even perverse. Yet the inter-community aspect alone commands respect.

3. *Good Results of Age.* "An old tax is a good tax." Not completely so, of course, except in some respects. Being old, property taxation has worked its way through the economy, especially the portion represented by rates other than the increases of recent years. Some elements have been capitalized and other adjustments made so that conditions are better than they may seem. Inequalities and crudities lose some of their sting as men adjust to them over the years.

Most significant, however, is the fact that in a meaningful sense part of the tax is no current burden on the present owner or user. In most communities perhaps 15 percent—often more, I think—represents tax on land values at rates which have existed for such a long time that most present owners allowed for it in the price they paid. You would not have an easy time convincing the homeowner of this point. Yet part of what he pays over to his local treasury each year does not really leave him worse off as compared with what would have been his situation if the tax had not applied when he bought the property.

4. *Administration.* Good administration and compliance are possible. Together they probably cost less per dollar of yield than with any alternative source of large revenue.[1]

5. *Taxpayer Awareness.* To a large extent in most localities (New York City with its large proportion of renters as against home owners being a big exception) property taxes are sufficiently out in the open to assure considerable taxpayer consciousness—and in a way related more than only incidentally to the services to be paid for. (Yet the tax can also get something from nonresidents.) Presumably this tie will contribute somewhat to rational balancing of cost and benefit in local government, though realism must inspire caution in conclusions along these lines.

Here, then, is a big revenue source. It will be with us as long as

[1] Obviously, the text statement lacks precision. What is "good" administration as envisaged here? Data on comparative costs of tax enforcement—governmental plus taxpayer—are incomplete. Income taxes at high rates bring in large amounts at low per dollar cost to government. We do not know the compliance costs for taxpayers—keeping records, filling out returns, etc.—except that for income tax they will likely be very much greater than for property tax.

we live, even the youngest here, and with our descendants. The issues which justify attention in hours of serious concern are not only the effects of the tax today, but also the strengths on which to build and the defects to remedy.

Who Bears the Ultimate Burden of the Property Tax

To judge a tax wisely, there is need to know who really bears it. He may be a person very different from the one who writes the check. Sometimes when taxes are shifted—as from building owner to tenant—the process works rather clearly. Often, however, the process is both obscure and slow.[2]

A change in tax will fall on the owner or, depending upon contract and market conditions, upon the user if he is someone else. With the passage of time, the following incidence will emerge: Of the portion of the tax rate which will have been in effect for some years—that is, most of the rate existing at any time—the burden on *structures* is borne by the *user*. Tax on business and other utility structures will in general be shifted to consumers.

The tax on *land* values is *capitalized into land prices.*[3] In effect, the owner at the time of each jump in tax rate will have suffered a loss of capital value, except as the spending of the funds adds offsetting benefits which enhance the demand for the property. Present users of land as they pay tax are not in fact truly worse off by the amount they pay. If the tax had been lower, they would have paid a higher price (or rental rate). The "saving" in tax would then be offset by other costs.

As ultimately shifted, is the tax (or are the taxes, for I insist that "the" property tax is two taxes economically) fair? The search for tax equity rests upon the best of instincts. Taxation represents government's use of coercion. And all use of compulsion should be just. But what constitutes *fairness* in sharing the costs of government? Would further increases in property tax rates be a

[2]For a more complete analysis see W. J. Shultz and C. Lowell Harriss, *American Public Finance*, 8th ed. (Englewood Cliffs, N.J., 1965), Chapters XVIII and XIX. The effects of deductibility for purposes of income taxation modify the conclusions, but the differences are too diverse to try to examine here. Throughout this paper I neglect the tax on personal property.

[3]I use the term "land" to mean the original condition. Expenditures of time and effort in clearing, grading, etc. by past and present owners should be classed along with investment in structures for purposes here.

fair way to finance the rising cost of local government?[4] "Fairness" has more than one aspect. Again, my comments, are summary.

Regressivity: Burdens on Low Income Groups. Critics say that the property tax runs counter to one concept of fairness by burdening low income groups more heavily in relation to income than those with larger incomes. Such a *regressive* element does exist. And regressivity is generally believed to be inequitable, conflicting with "vertical equity." Men of goodwill can disagree in the degree of their condemnation. A little is not so bad as a lot—a range of five percent to three percent would call for evaluation different from seven percent to one percent; and the numbers of families at various income levels also make a difference. For the families with these incomes covering the great majority of population in a community, the property tax seems to be roughly proportional. Regressivity exists at the upper and lower tails of the income distribution. Rather few people are affected materially at the upper end. Where the tax does burden persons with low incomes more heavily than may seem fair and wise, there is a very large "pro-low-income" bias of the benefits paid for by the tax.

Still another source of criticism of high property taxes lies in "horizontal inequity": Taxpayers in about the same circumstances (in the same income group) do not receive essentially similar tax treatment. Where the criticism is valid, the chief culprit is poor quality assessment. In some communities properties of the *same type* are assessed unequally, and assessments vary *from one type of property to another.* Assessment inequalities are still greater in some cases than the corresponding inequalities which stem from poor administration of other taxes.[5] But you know that such defects can be, and are being, reduced. Leaders in this great reform are the leaders of IAAO.

[4]The answer should depend in part upon the reasons for growth of spending. For some discussion see C. Lowell Harriss, *Handbook of State and Local Government Finance* (New York: Tax Foundation, Inc., 1966); since that was written, the relative force of factors has changed. The greater pressure of employees for higher pay may, or may not, reflect better quality of service.

[5]Other criticisms deserve at least footnote mention. Not all taxpayers have equal opportunity to get a property tax assessment *reviewed for possible correction.* Although "on paper" every owner has the same access to facilities for appeal, the real-life difficulties vary greatly. Another source of inequality affects the low income groups of some cities. Families who live in private housing will pay more property tax than those who live in "public" housing. Rent control also distorts but does not reach outside New York.

The property tax runs counter to another concept of fairness by burdening some businesses (railroads?) and types of consumption more than others. For example, families which choose to use above average portions of their income for housing tend to pay relatively more of the cost of local government.[6]

The property tax would not show up as a model of fairness in the distribution of burden among families. But with the best quality of administration found today—and which ought to be found generally in a few years—the tax would score reasonably well.

Perversive Character of Burden

The annual tax of three percent, or even when "only" two percent, on full current worth of buildings distorts resource allocation perversively where older property exists. New, well constructed, high quality buildings are taxed more heavily per unit of space than are slums and "junk." Can justification for such burden discrimination be found in the *cost* differences which the two types of property and their occupancy impose on local government per unit of occupancy space? Most probably, *no*. Just the contrary. The badly run down and less heavily taxed buildings are more likely to be associated with the greater costs per unit of usable interior space, if only for fire and police protection.

A property tax represents to some extent a cost to the private owner for which there is no comparable cost to society. When the tax is "greater" because the building is better, the private owner does not get correspondingly better governmental services. He pays more, but not because he puts the community to more expense. The buyer of a high priced consumer (or producer) good pays largely because that item cost more to produce (say, a Cadillac) than one with a lower price tag (Ford, Rambler or Plymouth). Not so, in general, the relation between the cost of property tax for the private owner and the cost to government of the differential services for the new and fine as contrasted with the old and decrepit (per unit of space).

Moreover, as compared with slum and low tax property, the high quality and high tax building brings the general public some

[6] Retail sales taxes exempt rentals, but building materials for construction and maintenance are taxed. Even after allowing for all effects, one finds housing taxed less heavily under the sales tax than most other types of consumption. The income tax treats owner occupants favorably.

"neighborhood benefits." The owners and users of dilapidated structures—the residential and industrial slums—will be freer from one type of economic pressure to replace with something better. The user's payment for the services of local government goes down, relatively, as the building gets worse, even though public expenses attributable to the property are unchanged or may even increase. The poorer the building, the less those who use it will pay for local government.

The person who wishes to shift from poorer to better quality housing, or business property, cannot do so without also paying more toward the costs of government—\$1 of taxes for each \$3 or \$4 (or in some cases as little as \$2) of pure occupancy expense. Ordinarily, however, such a shift to better facilities will not add to the services received from, or the expense imposed upon, government.

Obstacles to Urban Renewal

Heavy taxation of new buildings must stand as a tragically apt example of mankind's creation of needless obstacles for itself. Cities which urgently need to replace obsolete, decayed, degrading buildings nevertheless put powerful tax impediments in the way of progress. Nobody "planned" to set up a tax system with such influence. No one tried deliberately to base local finance on a tax that would favor holding on to the decrepit structures, many of which spread evil influence through a larger section, while penalizing the new, the good, the source of benefit to the larger neighborhood.

Assume that a new building will have a life of 60 years. Its construction involves the owner in a commitment to pay property tax for each of 60 years. The magnitude of these future tax obligations can be expressed in terms of today's dollars. To do so, each of the 60 tax bills must be discounted at some rate of interest to compute the present worth. If one assumes five percent (too low today, of course) and a tax rate of three percent a year on the construction cost, and makes some rough allowance for reductions in assessment as the building ages, then the *present value* of the taxes due over the life of the building will equal about 50 percent of the construction cost.[7]

[7] Gaffney, M. Mason, "Property Taxes and the Frequency of Urban Renewal," *Proceedings* (Harrisburg: National Tax Association, 1965), pp. 272-285.

The desirability of putting capital funds into new buildings varies inversely with the tax rates. The property tax on structures creates an incentive against upgrading of quality by new building. even in just those parts of older cities where need seems greatest, but tax rates are so high. Such discouraging of private effort to raise quality serves no useful public purpose. The tax on the pure land element, in contrast, can work to hasten putting land to better use by replacing old improvements with better ones.

MAINTENANCE VS. DETERIORATION

The work of the assessor brings him into touch with another effect of the tax on buildings—some discouragement of maintenance and modernization. Partly because of the realities of assessments as made, and partly because of what people believe the assessor will do, maintenance and improvement of existing structures lag.

Most Americans must live most of their lives in "not new" housing. Much will have been built before their birth. Housing will gradually lose its ability to provide satisfactory shelter unless labor and materials are devoted to offsetting the effects of time and use. The quality of the residential space actually available will depend greatly upon the maintenance of the stock of housing.

Under-maintenance forms one way by which an owner can reduce his net investment in a building. (His reasons for doing so may be good or bad and quite unrelated to property tax.) His actions affect others. The maintenance done, or not done, on even a minority of properties can materially affect a larger neighborhood—for ill or good. Outlays for maintenance can be combined with spending for improvement. In time, the owners (and occupants) of housing may do more than merely preserve earlier quality. Good effects due to betterment will "spill over" into the neighborhood. Any reasonably complete social system for making the best of the huge stock of existing structures will assign key roles to the prevention of new deterioration and the avoidance of discouragement of improvement.

The property tax on buildings works against us. The influence is a matter of degree, of course, and in many communities may be little worse than one must expect from any tax of equal yield. Property tax payments reduce the net return from property and

thus its attractiveness as an investment.[8] Moreover, the owner may believe that maintenance expenditures will lead to higher assessments. The higher the tax rate, of course, the greater are likely to be his fears and thus, also, his incentive to avoid actions which may raise his assessment; and so, perhaps irrationally, he may spend less than he would otherwise. Purely maintenance outlays should not affect assessed values except by influencing the rate of deterioration over time.

An owner seeking to act in a logical way would not be deterred by real estate tax in maintaining his property if such investment offered the best after tax return. And under our rules any net improvements the assessor spots should go on the tax rolls. In fact, however, misconceptions can exert influence. The owner may fear that a "repair and maintenance" job having visible results (or even one reported to the authorities for getting a building permit) will result in an assessment increase.

Do high tax rates on buildings deter maintenance more than rationality would justify? Are the types of maintenance which owners do make less generally those which are wisest economically, structurally, or aesthetically and socially? Do owners favor forms which are not likely to trigger an upward reassessment, e.g., "inside" as against "exterior"? We need more systematic evidence on such questions, but I believe that the answers we would find unwelcome are the ones most often correct.

Not all owners of real estate are well versed in property management. Many suppliers of rental housing own one or a few properties—a two or four family building acquired as a home and a source of rental income, the place where the family business is carried on, inherited property, etc. Their attitudes, beliefs, information, and financial capacities will, of course, differ in almost every conceivable way. But we can be sure of one thing: the cumulative effect of their decisions about property maintenance will have a material effect on the quality of housing. When a recent survey asked tenement landlords about the factors which determined their

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[8] Owners who rent out properties but do not get a return on investment equal to that obtainable currently in alternative forms will be especially sensitive to increases in taxes as a cost. Any rise will be especially onerous if a considerable time is required for full shifting to tenants. The incentive to make outlays needed for maintenance will hardly benefit. Any force depressing net yield will probably induce some decline in the supply of structures by under-maintenance as it reduces average quality. See James Heilbrun, *Real Estate Taxes and Urban Housing* (New York; Columbia Univ. Press, 1966).

outlays for maintenance and improvement, the replies indicated that rising tax rates had hindered maintenance by reducing the income from investments and by adding to the fear of upward assessment.[9]

Inducement to Smaller Structures

The property tax on buildings produces a rarely recognized effect which imposes what economists call "excess burden." The tax deprives the consumer of more real benefit than the dollars which are paid for the government.

As assessment manuals show, the expense per cubic foot of construction declines as the size of the house, office, display area, apartment or other unit increases.[10] In terms of one of the major things generally desired—cubic contents—unit cost drops as room size increases. One estimate, for example, finds that if the cost per cubic foot of a more or less typical, good quality, single family residence of 1,000 square feet is 100, the cost per cubic foot for the same type of construction goes up to 115 if the unit has only 700 square feet and drops to 86 if the size is 1,600. For another type of construction, with 1,000 square feet size as 100, the cubic foot cost is 23 percent higher for a 700 square foot unit, and 20 percent less for one of 1,400 square feet.

The decline in construction expense per unit of enclosed space reflects the fact that cubic content rises more than proportionately to floor, wall, and ceiling area. Moreover, much the same plumbing, wiring, kitchen, heating, and other facilities can serve larger as well as smaller rooms and buildings through a range of sizes. The general public welfare can be served best (within a range) by the construction of rooms, houses and buildings of larger, as opposed

[9] Sternlieb, George, *The Tenement Landlord* (New Brunswick, 1966).

[10] Morton, W. A., *Housing Taxation* (Madison, 1955) develops the point. The higher the price of housing, the smaller the quantity of space purchased. Similarly, the *quality*, the amenities, enjoyed will be less as their cost goes up. The property tax by adding to price will reduce the demand for both quantity and quality. Each one percentage point of higher housing cost leads consumers to settle for about one percentage point less of quantity, including amenities. Averaging over the years, it seems that the dollar amounts spent on housing by a family of given income will be about the same whether property tax is somewhat higher or lower. To make up for a higher price due to tax, the *amount* and *quality* of space obtained will be curtailed. Dick Netzer, *Economics of the Property* (Washington, 1966), 63ff., drawing on Margaret Reid, *Housing and Income* (Chicago, 1962).

to smaller, size. Resource allocation in the economic sense will be more efficient when labor and raw material are used for more commodious or less cramped housing, office and other use. The property tax on buildings, by adding to occupancy costs, creates pressure for building smaller units; in doing so, the tax makes for poorer resource allocation.

Not observably from one year to the next but unobtrusively and mixed with many other changes which occur slowly, the property tax on buildings—through the effects on demand—will lead to the construction of rooms, apartments, and buildings somewhat smaller than would be built in the absence of tax. The smaller units are not so good and yield less utility per unit of input. The public unknowingly deprives itself of opportunity to exploit fully the potential benefits from the "law of the cube." Thus, the public bears a hidden burden by sacrificing the benefits of greater economies in construction, per unit of space and quality.

Tax Islands and Central City Difficulties

Differences in effective tax rates among localities have other non-revenue results. Rates much above average in one locality will reinforce opportunities and incentives for creating "islands" of relatively low tax rates nearby. Among the independent governments in a general area, a few with tax bases which are much above average in relation to service obligations can get by with lower rates. They can attract capital for new structures and become low tax enclaves, perhaps predominantly industrial and commercial. Per unit of output or sales, the firms operating there incur below average property tax. They get something of a competitive advantage while (with their customers) bearing relatively little of the cost of local government anywhere. The number of such localities cannot be more than tiny in relation to the economy as a whole, but particular cases can be of importance for a metropolitan region.

Some communities, perhaps by the use of zoning power and building codes, are able to exclude types of property associated with high governmental expense. They may, for example, prohibit high density housing which brings many children and heavy school costs. The kind of housing used by claimants on welfare can be largely (or for a time in new communities entirely) excluded. The independent jurisdictions of a metropolitan area which succeed in such policies can hope to finance relatively high quality local service with a property tax which is less burdensome than those nearby. Tax rates in the latter, however, will tend to go up under modern pressures even though services are at a lower level. I put great value on those aspects of our system which embody and support the advantages of freedom and opportunity for differences in ways of living; but they do have less welcome results stemming in part from local autonomy in property taxation.

As regards buildings, not land, lower tax rates here and there on the fringes of an urban area encourage dispersal and the development "far out" of activities, including housing, which in a full economic sense ought not to be so distant. Property nearer the center will be subject to high tax rates; and each increase in tax rate will reduce the value of the property and the tax base. The land cannot leave. Improvements can, and will, shift location, slowly perhaps. Many of the buildings will already have deteriorated but yet have years of useful life, and of prolonged decline, before replacement becomes economical. But they become less profitable. And as the tax base goes down, the decline in itself adds to the need for still higher tax rates.

You know how in many cities the forces of the modern economy and society have made central city business properties, especially commercial ones, vulnerable to competition from outlying neighborhoods (or unable to rise to share in the boom of our economy). Tax differences can aggravate the troubles as (effective) city rates rise, due in some cases to lag in downward revaluations for tax purposes. Unless the users of property believe that the benefits of local government go up with the rises in tax obligations, the repelling forces gain strength. Yet the destructive process, one somewhat self reinforcing, may be scarcely perceptible from one election to another.

The existence of enclaves where tax rates on structures are relatively low, "tax islands," will work more than the two kinds of harm already noted, adding to the fiscal imbalance of neighboring localities and accentuating the difficulties of older areas. In addition, the region as a whole may suffer. This pattern of taxation as applied to structures (not to land) arbitrarily—and the arbitrariness must be emphasized—favors *horizontal* over *vertical* growth in metropolitan areas.

Other residents of the area—businesses, commercial establishments, and professional persons for their practice—may wish to

escape the urban center (for reasons among which taxes may not rank high). Almost all must then "leapfrog" over the enclaves with their policies of exclusion. The movers must go further out than would be "normal" if taxes were not distorting. The resulting land use then imposes higher costs on the whole society than if the population were spread more rationally.

The extra disadvantages take several forms: heavier costs in time and money for traveling greater distances from home to work, and for recreation and perhaps schooling; higher expense of supplying water, sewer, and utility services farther from central locations; and reduction in the economic and social benefits which population concentration brings. The last benefits are more numerous and more real than one might expect from the literature about urban malaise and from the "nice place to visit but I wouldn't want to live there" statements one hears frequently from visitors to cities.

The total of these tax originating tendencies cannot be measured; nor can their future force in the economy be quantified. But they ought not to be ignored, especially in view of the feasibility of counteracting them by shifting burden from structures to land.

Property Tax as a Business Tax

As the property tax falls on business, affecting both prices and the processes of production, it influences not only the quantities of productive property. Property taxation also affects business decisions about *when, where, how much,* and in what *forms* to operate and to invest in productive facilities.

The influences which grow out of tax considerations will rarely be constructive in the sense of helping companies to produce more efficiently. In general, tax created additions to business operating expense are undesirable.[11] Businesses are overwhelmingly the source of income. In taxes, however, they encounter impediments—costs for which there are usually no identifiable aids to production. For example, income or sales or property taxes, unlike wages, do not pay for services received by the business firm and helping it to create income. Lawmakers yield to powerful temptations to tax

[11] For more complete discussion see Committee on Federal Tax Policy, "Taxing Business Enterprises: Some Principles," *Tax Review*, Vol. XXX, No. 7, July 1969, Tax Foundation, Inc.

people *indirectly* through business, rather than *directly* on their receipt of income or use of it in consumption.

The significance of the property tax for business will depend in part upon the relation between the tax and the governmental services provided. Most services provided by local governments—education, welfare, sanitation, protection—are more for the consumer than for business as such. The expenses of city government are not of a type to be, in large measure, of direct benefit to business firms.[12]

Managers must take account of property taxes in making business decisions, such as where to *locate*. Other location decisions affected by property tax are by no means individually dramatic—perhaps scarcely identifiable. Some businesses, of course, are firmly attached to a location; e.g., those providing local services. They will not leave if the tax rate goes up, but their growth or decline will be affected. Firms which deal in highly competitive markets cannot afford to incur avoidable costs which do not, in return, either yield a salable output or reduce other costs.

Each rise in property tax unless matched by improvements in local services *to business as such* will tend to reduce the business use of structures because an element of cost has gone up. The amount of production in the locality will fall below what would otherwise be the case, going down not at once, perhaps not observably, but gradually. Or in a generally expanding economy, the effect in most localities will be slower growth rather than any absolute decline.

The competition among communities for industry grows. Some competition takes the form of property tax favors. Occasionally it is out in the open, but concealed assessment favoritism is not unknown. Community leaders may be acting most sensibly in trying to include within their boundaries companies which would pay "high" property taxes while selling outside. As a result, people elsewhere would then pay some of the costs of local government

[12] Differences in quality of local education will be significant for employers. Yet will not wage rates be higher where schooling turns out more productive workers? Probably so. Will wages be enough higher to offset all potential benefits which businesses may have expected from higher property taxes for better schools? The answer does not seem clear in theory, and empirical evidence is not available. Businesses do not, of course, have the right to vote. Managers, owners, employees, and consumers will have diverse interests. Many in this land of "one man one vote" have no vote in some localities which seek to tax them.

where the plant is located. The net effects are not known to me.[13] But the localities which do impose high property taxes on business are somewhat less able to maintain and build their economic base.

PRESSURES FOR "SOCIALIZATION" AND EXEMPTIONS

If time permitted, other effects of property taxation would warrant comment. One is what we may call "inducements to socialization." This rather imprecise and colored expression refers to attempts to lower the cost of something by providing it through government instead of private ownership. High property tax rates stimulate somewhat the expansion of the scope of governmental activity by giving misleading signals of the relative desirability of governmental, as compared with private, ownership. "Public housing" and governmental ownership of utilities are the chief examples.

Exemptions have properly been getting more attention when property taxation is discussed. The higher the tax rates, the greater the incentives for some groups to press for exemption. The chain effect will be familiar to you.[14]

[13] Competition, however, limits the possibility of one locality's getting much revenue from non-resident consumers. Each of the countless communities granting property tax favors, in a sense, "tells" the potential consumer elsewhere, "You can buy products created by factories, or services rendered, within our borders without paying (much) toward the cost of *our* local government." The tax treatment of the tangible property of business can influence business operations. Some distorting effects on inventory practices are familiar to many of you. Grown people ought to be able to agree to adopt procedures much better than those still used in some parts of this country: let them merely follow the examples successful elsewhere. Moreover, the extent of use of machinery and equipment as compared with structures and inventory must also be influenced by property taxation. The net results can only be more adverse than helpful to efficiency.

[14] Some groups, we often feel, deserve help; one way to provide it is to grant tax exemption. Who, for example, will not sympathize with an old couple living on a modest income which they have no opportunity to raise and who are called upon to pay higher property taxes to finance school expansion? Although the tax itself may not, in fact, be a large part of the source of distress, it can be a focus of pressure for relief. Here is something government *can* control. Agricultural land on the urban fringes presents another type of case which sometimes seems to call for relief when taxes as well as values go up; but in view of the capital gain being accrued, the owner would seem to have become one of the highly favored of society rather than a justified claimant for tax favoritism, except perhaps for postponement. To lawmakers—and the public—granting relief in the form of

The cumulative effects of my remarks may have an imbalance that misleads. *Any* account of only one side of a set of large money transactions—the benefits (of spending on streets or schools or furniture) or the costs (taxes or payments for goods)—will give an unbalanced view. Proposals for more government spending frequently fail to accord reasonably equal attention to the (marginal) effects of the (added) taxes needed to cover it, including nonrevenue effects of the kind I have been discussing.[15] And *vice versa.*

A much happier aspect, however, has made me willing and anxious to deal with unpleasant realities. The brighter side is a conviction that in this case of taxation—and none other comes to mind—a feasible alternative would raise the revenue with substantially fewer bad results and some good ones.

No Easy Road to Progress

Nothing in taxation is ever easy. And the proposal now to be advanced would not really be easy. Yet in relation to the prospective benefits, the difficulties seem so moderate and the proportion of beneficiaries to sufferers so large that we ought to be able to progress substantially.

To begin, let us repeat: In an economic sense "the" tax on real property is not one tax but two—because of the very different natures of land and buildings.

1. *Land* in the sense of space on the surface of the earth is fixed and cannot move. Rarely will the amount in an area be subject to more than the tiniest of change—by the filling in of low land, extending surface into water areas, drainage, erosion, and other actions which are under man's control. Space will continue to exist regardless of almost anything individuals or governments do by taxation or other public policy. But tax can affect the way land

tax exemption can appear easier than an increase in expenditure directed toward the particular need. In fact, however, exemption tends to be a crude and inefficient device in that the benefit provided to those in *real* need tends to be small per dollar of revenue loss.

[15] Fundamentally, man cannot escape the problems of scarcity by any magic or any pushing of problems to government. Yet the individual or small group may hope to benefit considerably on balance because its payments will not equal its benefits. And taxpayers have incentives to alter affairs to escape tax, as noted above, so that the secondary and tertiary effects can include costs greater than those of payment of a *quid pro quo* in the market.

is used. The higher the tax rate on land, the greater will be pressure on the owner to put the land to "higher and better use." Society can actually benefit from a tax otherwise than merely by getting funds to pay for government.

2. *Buildings and other improvements* result from man's actions, being constructed and destroyed as seems to the interest of the owner (subject to governmental influence from zoning, building codes, and use of the power of eminent domain).

The basic element would be a much higher tax rate on land than on improvements—an old idea. The effective rate on land might be three, four, or even a bigger multiple of that on improvements. Though the tax on buildings would not disappear, the rate would drop to a small fraction of the present level. Such "detaxing" of improvements would in principle equal the rise in burden on land so that the total net result would be no change in total tax.

Even now, without any alteration of state constitutions or statutes, steps could be taken. Raising assessments on land within the scope of present law (with equalizing adjustments on buildings) could make a difference in quite a few communities. More of the total tax than at present would be attributable to land, less to structures.

More use of special assessments would often be desirable. Another possibility has highly attractive potentialities. It would consist of transforming some of the tax based on value into taxes related to amount of land area and location relative to city center. Although the thought of a tax on increments in land prices has appeal, the possibilities are not promising.[16]

[16] If capital gains are subject to income tax, some of the increases in land prices will in effect go to finance governmental spending, chiefly at the national level, a little for states, virtually none for local government. The tax on capital gains will apply to land values only in those cases in which land is sold. Present treatment exempts from income tax all capital gains not realized before death. A tax on all increments in land values (as distinguished from other capital gains) does seem desirable, in principle, to yield funds to the government of the locality (a general area rather than very small districts) where changes in land value occur. The tax should rest on an accrual rather than a cash and realization basis. I doubt that anything of this sort would be workable. Moreover, not all of what would appear as increments in the worth of land do result from social forces, with the owner passively taking only "what comes." Some owners by their investment of capital in land and their efforts do actively influence what happens. A high rate increment tax might endanger constructive effort of such a kind.

What Would Be Gained

Two different non-revenue benefits could be real and substantial: (1) a better pattern of land use, and (2) larger investment in new structures with faster replacement of old ones.

Higher and Better Use: The necessity of paying tax, at high rates, based on full current value (or a tax based on surface area or location to pay part of the costs of governmental facilities) would sometimes force an owner to use land more effectively. Where land is held out of the "highest and best" potential use for whatever reason, a tax payable in cash would add inducement to find and adopt the type of use which will bring more income. Withholding land from use while waiting for its value to rise would become more difficult.

More Active Market: It could be expected that one result of the force noted earlier and of the one to be mentioned next would be a more active market in land. A better market would result and with it more opportunity for efficient land assembly and subdivision. Allocation among potential uses would tend to conform more closely with the changes of alternative possibilities.

Indirect Easing of Financing: A tax increase on land reduces its price. In effect, a new purchaser would pay *less in price* (and later in interest) after a land tax has been imposed than he would have paid before. But he will then pay more each year as tax. Government in a meaningful sense has changed the conditions of ownership. The change favors the person with less capital, without burdening or making things harder for the person more amply supplied with funds. A buyer can acquire land with a smaller outlay of his own resources and with lower annual financing charge (interest plus amortization). He must, however, pay more each year to government.

The Element of Justice: Raising the tax on land does work against present owners of land. But building values would tend to rise with the drop in tax rate on improvements. In the short run, therefore, much of the result on land prices would be offset for the "average" owner. Over the longer run, present and future landowners would get less of the increment in land values. More would go to pay for the costs of local government. This tax on pure "economic surplus" (or on the product, largely but not entirely, of government spending and social growth) seems to me about as fair and equitable as any imaginable. "The best of taxes."

More Investment in New Structures: A reduction in the tax rates on buildings would reduce certain ill effects outlined earlier. Most important would be encouragement for more investment in new construction. Every decision involving the construction, modernization, and use of buildings must be weighed against the tax results. The greater the tax, the fewer the number of investment projects—and the smaller the number of dollars put in each—which will yield a satisfactory after tax return. The lower the tax rate on structures, the more housing (in quantity and average quality) and the more investment in other types of buildings can be expected.

Substantially higher taxes on land would induce owners of low-use land to convert to higher value uses. Meanwhile, the lower tax rates on buildings would encourage replacement of old structures by new ones, as well as net additions. The benefits could be appreciable in a generation—not revolutionary, not earthshaking, but highly significant.