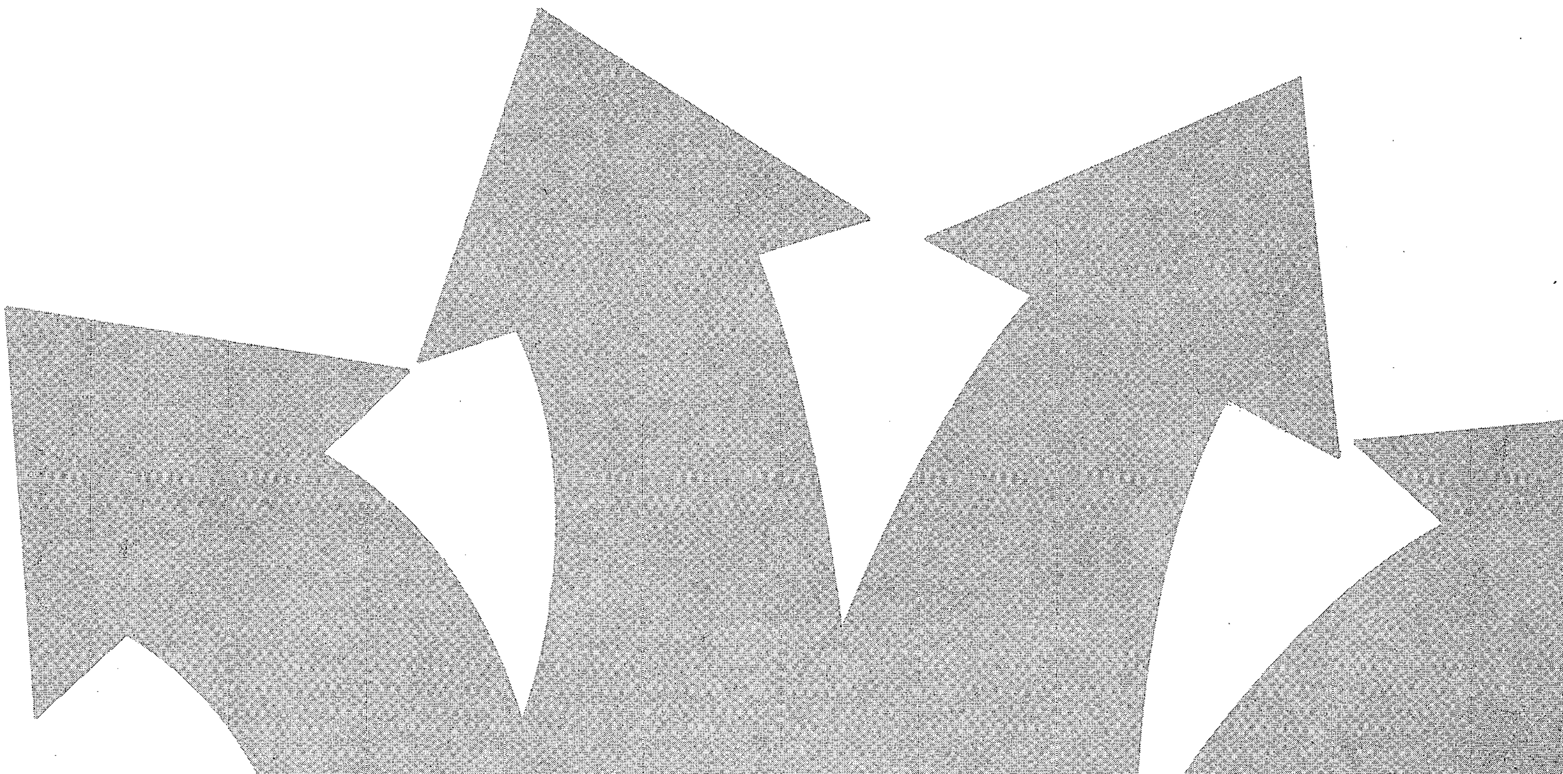
THE IMPACT OF INFLATION ON PROPERTY TAXATION

Americans must prepare to deal with property tax difficulties stemming from both the economic disruptors of probable inflation and added strains of the administrative organization



By Robert C. Brown and C. Lowell Harriss

INFLATION assures trouble in property taxation—lots of trouble. Local governments cannot hope to moderate the force of inflation. But municipalities, along with the state governments from which they get authority, have responsibility for the property tax. By facing realities, they can adjust more or less effectively to the conditions created by inflation. Most of what the element of inflation makes desirable ought to be done in any case as a constructive element of good public policy. The inflation from World War II into the mid-1960s, say 1946 through 1965 but excluding the Korean War, was at an average rate of 2.7 percent a year (Consumer Price Index). This inflation created some property tax distortions and dislocations; but for the most part the results were a modest portion of the total changes produced by many forces of a rapidly changing economy. Then, with rapid expansion of domestic programs, expansive monetary policy, and our participation in Vietnamese hostilities, inflation accelerated. And the rise did not stop with the end of fighting. Just before Organization of Petroleum Exporting Countries (OPEC) raised the price of oil (September 1973), prices were 42 percent above those at the close of 1965. In the four years since OPEC's first big action, the Consumer Price Index (CPI) has risen from 135.5 to 182.6 (1967=100).

Today, reluctantly but inevitably, Americans looking to the future will assume a condition which a decade ago—and through the broad sweep of our history—would have seemed unrealistic. We expect inflation to continue at a rate perhaps double or triple what might be termed nominal and incidental—not one to two percent a year but perhaps over, rather than under, five percent. In no more than one Presidential administration, at five percent a year the dollar would lose 22 percent of its purchasing power. In ten years, not really very long in the life of a municipality or even a family, the price level would go up by 63 percent. Seven percent a year compounded would come to 97 percent in a decade.

Municipalities will need more dollars to perform the same functions. City officials face an unpleasant prospect. Although this result of inflation must be obvious, taxpayers can be reluctant to concede the inevitability of paying more taxes year after year for no better services. Popular opposition and frustration can cumulate into a focus on the property tax—a major source of local revenues. Tax bills are not expressed as "constant dollars of 1972 purchasing power." The really much bigger amounts of 1979 dollars will be due.

This article assumes that general inflation will call for more dollars for local treasurers even without more services. What then, will be the effects of inflation on the property tax, with its capacity for meeting the rise in dollar needs? We are also concerned with ways that property taxation can be improved as a central element of civic life.

Americans must prepare to deal with property tax difficulties stemming from both the economic disruptions of probable inflation and added strains on the administrative organization. New strains will aggravate what has long been a deplorably weak aspect of the tax as it exists in most places—assessment. Complications must also be expected from another aspect of property taxation as it exists in many localities—the political. Voting power and less formal political means of influencing governmental actions always exist as potential or actual forces bearing upon what really occurs in property taxation.

RISING TAX BASE. By inflation we mean a *general* rise in prices—the price level. Not all prices, however, rise by essentially the same percentage in either the short run of a year or so or over longer periods.

Real estate, the major element of the property tax base, has in most of the country gone up by more than a broad average of prices.

One study found that in the period 1968-1977 the compound growth of the CPI was 6.2 percent a year. Farmland rose 11.1 percent and housing 8.6 percent. The excess of housing over the CPI—2.4 percentage points a year—may not seem large; but it produced a differential of nearly one quarter in nine years—for the year 1977 housing at 210 compared with 172 for CPI (against a base of 100 in 1968).

Such increases, along with the prices of machinery and the many items of business inventories, obviously expanded the potential tax base in a dollar sense. (We ignore here construction in excess of demolitions.) Therefore, it would seem, local governments by bringing these price increases on to the tax rolls can get more dollars—perhaps with some reduction in tax rates and whatever political plaudits may be garnered by citing a rate cut.

A crude sort of "reasoning," therefore, might lead one to conclude that local treasuries will be beneficiaries of inflation as it occurs; such an apparently favorable result would, of course, be most marked where real estate prices continue to move upward faster than the wage and price level in general. Although forecasting must lack certainty in a world in which people are free to change their minds, there seems to be a high probability that the potential dollar base for taxation will expand faster than many other major magnitudes. Whatever the results, however, they will be diverse and complex—neither "easy money" for local treasuries nor inevitably inescapable additions to real burdens for property owners.

LOCAL VARIATIONS IN PROPERTY TAXATION. American property taxation differs widely from place to place. State laws vary. And within most states community implementation varies significantly. The tax responses of communities and regions to inflation will reflect differences in their own economic conditions. For these and other reasons, generalizations about our subject must be made cautiously.

Tens of thousands of local governments use the tax. Inherently, real estate is local; by its very nature the tax base must reflect conditions that to some extent are unique to each particular community. Prices of real estate have changed relatively more in some areas than in others. People can "do" something about this tax, most fundamentally by affecting the local expenditures which determine the amount to be collected.

The weight of property taxation varies enormously. In five states in 1975 the tax per $1000 of personal income was $22 or less, against the median of $45 for all states; the problems in those states will seem important to the participants and will warrant concern. But the magnitudes will be in a range very different from those of commununities, and even a few states, where the tax averages more than $65 per $1000 of personal income.

Traditions have grown up reflecting local conditions, various discriminations being tolerated or even endorsed—favoring home owners, undertaxing vacant land, hitting utilities. Recently, some local practices have changed considerably, much more so in some localities than in others. Court decisions compel new procedures and results, such as full-value assessment; ahead of us lies more response to past judicial directions *e.g.*, the *Serrano*-

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type issue. Rising rates combined with more favorable procedures are leading some owners of property to press with more determination for the rights apparently due them—assessment equality rather than toleration of adverse discrimination. Improvement in administration stemming from one or more forces has been real but far from uniform. Laggards are legion, but their number does decline.

CONDITIONS WIDELY ASSUMED IN AMERICAN TAXATION OF PROPERTY. An understanding of the problems now facing property owners and municipalities will be aided by taking explicit note of certain more or less basic assumptions of property taxation in America.

1. The tax is neither an income nor a net wealth tax. Attempts to judge it by criteria applicable to an income tax are inappropriate and will misguide thinking. (For example, the worth of land today may not be indicated by the money income from its current use.) At one time efforts were made to include intangibles but failed miserably—and for good reason. Deduction of debts to approximate a net worth basis would move toward an utterly different tax. Whether or not such a tax would be better, it is not what American localities now impose.

2. Property taxation is a key to the finance of government closest to home. It does much to make popular choices as meaningful, and local government as viable, as they remain. Cities, towns, counties, and school districts are increasingly subject to direction from outside. Yet we are convinced that in theory—and in practice, despite "horrible examples" of poor performance locally (but never on a scale so large as a nationwide governmental failure)—merit does lie in the use of localities, as distinguished from state and nation, to get some of the things we expect from collective (governmental, political) action.

Property taxation offers people in different localities an instrument by which they can make truly local choices significant. People in one community are not forestalled, inexorably, by the decisions of voters elsewhere. For example, we respect, and applaud, the wishes of those who do not want to limit their children to a level of education which might satisfy a majority of voters in a state. The property tax helps to provide freedom and opportunity to do things differently—not to be held to a level set by others who may live in areas which are quite different or who may have other values.

For this, plus other reasons to be noted later, we believe that among revenue sources the property tax can compare more favorably than now seems fashionable.

3. The tax rests more heavily upon administrative actions than do income or consumption taxes. The sales tax due upon a purchase or the income tax due upon the payment of wages will automatically utilize the decisions of buyer and seller or employee and employer to determine the dollar amount of the tax base. The tax, then, is incidental to a transaction which is concluded because the parties believe it desirable in their mutual interest. For property tax, in contrast, an official of government must act and express a judgment. The range for human discretion is enormous. The quality of results? Improvable.

4. Underlying Americans' use of the property tax has been a tacit belief that most real estate values will be largely stable from year to year. Almost as a matter of course, localities have relied upon procedures based on this assumption. The things to be taxed will get on the tax roll. The assessor will place a value. Then much of the assessor's job will be to keep track of new construction, demolitions, land consolidations and divisions, additions and removals of machinery, changes in inventory, and so on. With the passing of years, of course, land prices will change; the worth of existing structures will also change although in most jurisdictions depreciation has been recognized only slowly for property tax purposes. Most changes in value for tax purposes were expected to be gradual rather than large or sudden. Small staffs could handle matters.

The point relevant here is not so much that Americans have expected real estate prices to be stable year on end. Rather, there has been an assumption of enough stability to preclude the need to recognize frequent value changes in the worth of most elements of the tax base. Assessors' offices have not been geared to reassess annually all, or even most, of the properties on the tax roll. Reassessment on a four- or five-year cycle could serve tolerably well. Thus, in practice, albeit less generally sanctioned by statute, sequential reassessment became common. The exception was most often not the annual revaluation which the state constitution or statute might seem to require but irregular efforts often separated by many years.

5. Rather similarly, Americans could assume that from year to year local government finances would tend to change only moderately rather than substantially. True, after World War II, changes in total budgets often were "large;" but such cases were typically associated with community growth. New housing and other construction would add to the tax rolls and do much to meet the necessary increases in operating expenses. (Capital projects could be financed by borrowing.) Gradual adjustments in property tax rates would meet changes in revenue needs. A small rise in the millage (or at times a drop) could do the revenue-raising job and without the political strains of imposing a new tax or getting the legislature to alter a rate. (Moreover, until recently, possible alteration in state or federal grants from one year to another would not be large enough to create serious uncertainties.)

This picture, admittedly, an oversimplification, is presented to help in understanding how conditions seem certain to differ in the foreseeable future.

NEW CONDITIONS. Looking ahead in 1977, one sees the need to adjust to the disappearance of extensive elements of stability that existed in the past.

1. The *general level* of prices of taxable property does move more than a little from year to year—6 to 10 percent a year having been frequent. Larger changes are easy to find. During a four- or five-year reassessment cycle, the market values of a large portion of the parcels on the tax rolls

have moved significantly. They may continue to do so. The tax base consists of *specific parcels*. Each requires attention. Inequalities in changes among the various properties must be dealt with. The potential task may be enormous even though the rates of change in a locality more generally harmonize than diverge widely.

2. Inflation raises the dollar requirements of local budgets even when there is no increase in the work to be done. When no one can be confident about the cost of living in a year or two, employees and suppliers may be rational, and certainly human, in trying to get increases which are greater than the recent change in the general price level—"demands" for 8 percent when the average of prices seems to be going up 6 percent. Even if the municipality is spared such strains, the additional dollars required to maintain its position for, say, three years of five to six percent inflation can create troublesome difficulties. Voters who feel oppressed by inflation and helpless to do anything about federal or state taxes may try hard to restrain property tax increases that in fact are even less than inflation. Who knows?

3. The last point ties in with another. The tax rate. After years of creeping upward—the school district one year, the town the next, the county another—the effective rate is now high enough in many localities to create valid reason for concern about effects on the economy. Businesses which are the *source* of jobs and income operate in a country (the world, in fact) where competition for industry is very real indeed. One of the few actions open to a local government to attract or to hold employers may be adjustment of the property tax assessment and restraint on further increases in the rate.

4. Deterioration of parts of older cities and loss of their tax base will present distressingly burdensome problems. The realities are neither new nor unpublicized. In the communities receiving people and required to provide for them, values from greater demand for land and new construction will generally be positive.

5. Space limits prevent comment upon other topics—decline in school population as a potential relief for property taxation, public desire for more and better services (but in a world with "no free lunches"), federal and state grants, pension and debt costs, economies possible through better management. Except one point. Real incomes (adjusting for inflation) show every sign of continuing their upward trend. From year to year most families may sense little improvement. Yet Americans will be better able to support, if they wish, more expensive government—federal, state, local—along with more private consumption. No magic is in sight. But progress in productivity will enhance our command over goods and services, governmental and private.

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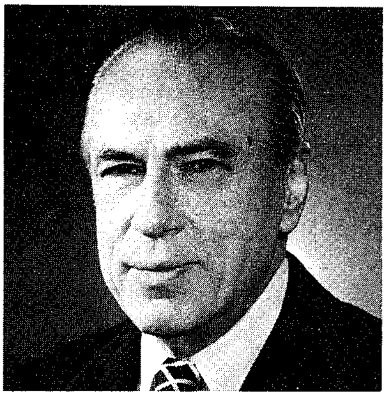

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CAUSES OF INCREASES IN PRICES OF REAL ESTATE. Many forces of demographic change, income movements, changes in family size, improved highways and autos, trends in personal tastes, and so on have been operating on real estate prices. Within a region, state, or locality, the specific changes can diverge significantly. The tax assessor's job grows in ways not evident in an economy of price-level stability.

After World War II population grew rapidly. This country has *added* more people than the total population of France plus the four countries of Scandinavia. Incomes also went up; in real terms (adjusting for price-level change) *per capita disposable* income in the mid-1970s was more than double that of 1929 or 1940, *raising* the demand for housing and for places to work and play. And "they aren't making any more." The increase in demand for space will have a relatively larger influence on land prices.

Shifting population—to suburbs—has accounted for some of the relatively large increases in land prices in some areas. The expansion of auto and truck transport enlarged the practical availability of "new" areas. Public outlays for schools, streets, sewers, and other governmental facilities helped to raise the market price of non-urban, even rural, land to many times the price per acre.

Construction cost increases have outdistanced most prices. And other forces operated in one way or another—direct and indirect governmental aids to homeownership, income tax provisions making real estate a relatively attractive form of investment in some cases, various urban development and the interstate highway system, these and others have influenced real estate prices.

Finally, we note that the prospects of inflation—now based on considerable reality—have led some investors seeking protection from inflation to acquire real property and have induced some owners to hold such assets when sale would have been the normal action. In many lands, during many centuries, and through innumerable inflations, the possession of land and buildings has preserved real

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value when money and many other assets have lost much of their worth. Our own recent history seems to confirm the principle.

DISTORTIONS OF ASSESSMENT RELATIONS. Where do we stand? What new problems must be faced? In even the municipalities with best procedures, changes in real estate market prices during the last few years have probably not yet been reflected fully in assessments. The common procedure, noted earlier, would produce a tax roll reflecting what happened in 1975 for some assessments, 1974 values for other parts of the community, 1973 in some, and so on. The inequalities that result are more frequent and greater than would have been assumed, and tolerated, in a world of stable prices.

Changes in the future will, one must assume, result from both inflationary forces operating more or less generally and all of the many market conditions that influence the worth of each specific location and what is on it—including, of course, new construction. The problem with which local governments—and state governments and also "the people"—must learn to live, somehow, is to make an *annual* tax conform to a frequency of value changes that in the past were brushed aside because the amounts (related to the tax rate) seemed too small to be troubled about.

If the general level of property prices is changing by several percentage points a year, then a four- or five-year cycle of the past will produce lags of differing length. The differences in two or three years will lead to inequities that exceed those reasonably acceptable.

If assessments are at even longer intervals, the discrepancies can become very great. When there is an eventual catching up, some enormous assessment—and tax—shocks will appear.

FAIRNESS AND EQUITY[1]. Responses to the conditions growing out of inflation will, of course, take account of prevailing views about the tax. One of the most frequently heard opinions is that the tax is inequitable because it is regressive. This conclusion seems to have been hardening into "an article of faith" just when the results of serious analysis have been leading in quite a different direction.

The issues are more complex, and the best judgments are subject to more question, than frequently assumed. (One aspect hard to allow for is the distribution of the benefits of the spending of the revenues.)

The term regressivity is generally used to mean that as a percentage of income the final burden of the tax (on the house or apartment, as an element in the charges for utility services, and as part of other prices) is higher, the lower the income. An example would exist if a $20,000 income family bears $800 in property tax (4 percent) while the $9,000 family pays $450 (5 percent). Perplexities arise because of doubts about who actually shoulders the various forms of the burden.

First, even though rarely recognized except by scholars, part of the tax is no current burden on the present owner or user. The amount to be paid has been capitalized, reducing the market price of the property, notably the land, at the time of the last purchase. In some communities, certainly, a significant percentage of the property tax represents (a) tax on land values (b) at tax rates which have existed for such a long time that many or most present owners allowed for it in the price they paid. This distressingly imprecise conclusion relates to an equity aspect of considerable importance: The annual payment of this portion constitutes no true burden on the user, whether owner or renter. This part of what goes to the local treasury does not really leave the taxpayer worse off, compared with what would have been his or her situation if the tax had not applied when the property was purchased.

A more general consideration grows out of the "modern" emphasis in analysis of the incidence of property taxation. This study concludes that much of the tax on structures and other man-made capital remains on the suppliers of capital. They have no effective way to shift at least a big portion of this tax to a tenant or customer. (An exceptoin exists, of course, when above-average taxes pay for local services of special appeal to families or businesses using the property.) For a homeowner there may be no significant difference between his bearing the tax burden in his capacity as a supplier of capital or as an occupant (consumer). The tax falls on the family. The burdens (over a period of years —a life time) may be proportional, regressive, or progressive. Something will depend upon assessment practices in the community.

For business property it may be hard to believe that a steel mill or auto factory or supermarket does not shift the property tax to customers. Space does not permit a discussion here of issues of tax shifting in an economy where capital has high mobility over the years. Suffice it to say that the portion of a local property tax on structures, business machinery, and inventory which is at a rate below or up to the general average of the economy will probably not be shiftable to consumers to any appreciable degree. The suppliers of capital must accept a rate of return which in fact is depressed by the tax. To this extent, the tax as one on capital will be generally, albeit quite irregularly, progressive, *not* regressive. Economists' reasonings, we recognize, will lead to somewhat different conclusions. The broad charges of regressivity, however, will not survive reasonable criticism. As to individual communities, the results can be affected by biases in assessment patterns. The most strikingly underassessed—and undertaxed—property tends to be vacant land. Owners are not necessarily persons whose income would "justify" (admittedly contrary to law) tax favoritism.

RELIEF FOR HARDSHIP. Current discussions of government policy typically urge sympathetic concern for the poor and needy. Income tax exemptions have been raised time and again. Several state retail sales taxes now grant annual tax refunds to provide more relief than the exceptions for rent and the traditional exemptions. Property tax aid for persons in special need is being provided in many states by "circuit-breaker" relief to the needy aged. Pinpointing relief can serve efficiently in the sense of according benefits for those in the community who deserve special consideration but without "large" cost in terms of loss of revenue.

Good intentions, however, can lead

to a real problem. Political forces will almost inevitably arise to urge the extension of benefits beyond reasonable limits. Caution should be the watchword. Erosion of the tax base by increasing the rolls of exempt property can cumulate. No clear guides will exist as to stopping points. The tax burden on others will rise. What, then, sets criteria of fairness? Whose hardship qualifies for relief—at the expense of others?

Whatever the emotional appeal of egalitarian arguments for relief of taxes on some, one inescapable conclusion bears directly on the finances of local governments. It is confirmed by experience. It demands repeated recognition in a world with the emotional forces so publicized today (writers and some politicians assuming that "government" must do still more to transfer income from one group to another).

Local governments cannot effectively do "much" to alter the distribution of income and wealth. Any practices of more than nominal amount will (1) attract and hold the needy and (2) repel those who are expected to pay. Cumulative adverse selection will erode the locality's economic base.

So far, the amounts involved in circuit breakers will scarcely exert significant influence which is adverse to the communities offering such aid. Yet one characteristic inherent in redistributionist aspiration—and agitation—is the lack of clear guides to "enough." As inflation aggravates the financial problems of some groups in the community, property tax revisions can scarcely be expected to offset more than a small portion of the unfortunate results.[2]

CASH POOR—PROPERTY RICH (OR PROSPEROUS). Practical difficulties grow out of the fact that inflation can raise the worth of assets without producing cash. And tax payment must be in cash. American history has innumerable examples of the owner of land which is in the path of progress. The owner enjoys a rising net worth which is not reflected in the cash receipts. Inflation multiplies the number of such cases. Persons with relatively fixed retirement incomes may own a house and want to keep living in it.

If the tax assessment rises to reflect the increase in the market worth of the property (and if municipal expenses go up to match infaltion), the cash for tax may not be at hand. Complaints can be expected. An apparently sensible reaction might be, "Don't gripe about what is your good fortune. Sell some of the property, or borrow against its higher value." But owners may powerfully resist either going into debt for tax payment or disposing of some of the property. Inflation creates a difficult practical problem.

Pressure for some form of tax relief has had results in many states. The state may compensate the municipal treasuries, at least in part. Or tax may be deferred. The variety of problems will lead to various responses.

IMPROVING ADMINISTRATION. For decades, even generations, much of the valid complaint against property taxation grows out of poor administration. Inflation increases the need to improve administration.

The property tax suffers from needlessly poor administration. In most areas the actual results remain far below the standards appropriate to modern life. Almost any adjective of opprobrium can be applied validly against administration as it exists in many places. Defects of assessment are unconscionably, and inexcusably, excessive.

Assessment at levels far below market prices continues, despite the long-established fact that underassessment exacerbates malassessment. But if, for some reason, people in a community do seem to "want" fractional assessment, they can get uniformity. And uniformity or equality of level of valuation is the important goal.

Methods for improving administration have been devised, tested, and improved upon. They are available to a receptive public. Yet no revolution can be achieved over night. Not enough qualified assessors could be made available. The precedents and practices of generations cannot be replaced in short order. Maps, records, and other facilities are still inadequate. So much that has long been known remains to be utilized!

New techniques using computers in the assessment process have proved themselves. In many places they will certainly make the job more nearly manageable—the job of keeping the figures on the tax rolls reasonably in line with market conditions. Where properties have a high degree of similarity, the new mass methods can take account of many somewhat minor differences in features and produce a tax roll which embodies the effect of recent general changes. The blending of uniformity (*general* trends) and diversity (allowance for *specific* features) that are obtainable can represent a substantial advance over what has been achieved in the past. That is, a much larger portion of tax assessments can reflect accurately, albeit not in minute detail, changing market conditions. Among the benefits from the use of equipment will be the freeing of personnel time and other administrative resources for dealing more accurately with properties that differ enough from each other to require individual attention.

Most of the tax base of municipalities, however, does not consist of relatively new residential developments of houses built from a few basic designs and thus most readily valued by the mass methods. The older, built-up urban areas we see in our daily lives—and the impressions one gets from the air—include diversity rather more than uniformity—that is, diversity of structures. The land underneath will be much less variable from one plot to the next; in various sections of the community land-price changes due to inflation and other causes will generally have some systematic relation growing out of their location. Keeping land assessments up-to-date should be markedly easier than for structures. And, typically, buildings constitute a large portion of the tax base of settled areas; adjusting their valuations to get reasonably accurate, up-to-date fitures is a task of formidable size in times of inflation.

The various kinds of business properties will present a variety of different problems. One, we believe, needs explicit consideration.

REGULATED PUBLIC UTILITIES. The property of regulated public utilities (including that assessed by the state government) makes up a significant portion of the tax base, ranging as high as one-tenth, even more in some places. Assessment methods differ considerably, as do the actual provisions for imposing tax.

In a period of inflation, complications can arise in determining what the property is "really" worth, and thus the proper base for taxation. The answer depends crucially upon the income the property produces and is expected to produce. Potential market demands may, or may not (as in the case of some railroad and local transit companies), be adequate to support values comparable to those of other properties, resting on current replacement costs. But in fact rate regulation affects earnings. The utility will not always be permitted to use its full market power.

The American system of public utility regulation developed without provision for inflation. As money costs (and properly computed allowances for depreciation) have gone up, rate adjustments have not typically kept pace. The story of regulatory lag is now familiar—and probably not at an end.

Where rates authorized do not take full account of the effects of inflation on utility operating costs (and where depreciation costs do not rest on replacement prices), then the worth of the property for tax purposes should be adjusted accordingly—downward relative to what might seem appropriate. Compared with reproduction cost, the actual current worth may seem too low to be believable.

The decisive element which can be overlooked in popular references (an oversight exploited by demagogic allegation) is the utility's legal *obligation to serve*—and to provide service under a rate structure that does not rest upon full recognition of current (replacement) costs. Compulsion exerts influences which cannot be escaped. They do bear upon the worth of the enterprise and thus on the (taxable) worth of the property used. No way exists for judging the future in this respect, but the economically accurate figures will probably sag far below anything to the taste of municipal treasurers and elected officials.

MODERNIZING PROPERTY TAXATION. Predictions over many years of the demise of property taxation as an important revenue source have quite obviously proved wrong. More recently the Advisory Commission on Intergovernmental Relations, responding to a request by former President Nixon, concluded that the tax should not be replaced on any large scale by some alternative for financing education.

Solid reasons do exist for continuing prominent reliance on this revenue source. But defects are needlessly large. Basic improvements can be made. The seriousness of the defects and the urgency of modernization differ widely, in part because of wide differences in effective property tax rates. Our concerns involve chiefly urban areas. We explicitly pass over any special problems of agricultural regions.

Fundamental and basic are the improvements in administration, some of which have been touched upon already. In addition, we note the need in much of the country for better procedures to appeal a proposed assessment. Too often, the best methods now available do not in fact give the taxpayer (whether owner or user) effective and economical opportunity for review and possible correction of an initial assessment. Where fractional assessment is the rule, the practical problems of obtaining equality of treatment can be formidable.

Payment must often be made in a few large amounts rather than as several more convenient installments. Governments could rearrange procedures to accommodate taxpayers more conveniently. Such in fact is the result when taxes are part of a monthly mortgage payment.

SHIFTING BURDEN FROM MAN-MADE CAPITAL TO LAND (SITE VALUES). A change in the basic framework of the property tax could have a salutary effect. A persuasive case exists for localities, especially those with high tax rates, to reduce the burdens on buildings, machinery, equipment, and inventory and to rely more heavily on taxes on the land itself. The multiplication of tax rates, the tragic problems of many cities, and other considerations now add force to arguments that have a long history.

A five- or ten-year transition could provide a gradual shift to a substantially different structure. The goal would be a low rate on man-made capital. A higher rate would apply to site values. The actual levels would, of course, depend heavily on local government expenditures and other revenue sources. The changes in the tax structure would themselves alter tax base by effects on the flows of new capital and the capitalized values of land and existing structures.

A high tax can be counted on to reduce the quantity of the taxed item. Land, however, is an exception. Normally land does not come into existence because someone paid to get it produced. Yet a high price is paid for the use of certain land.[3] What community today has more land because the price which people must now pay averages much more than was paid a generation ago? If more of the rising payments for sites had been channeled into the local government's treasury, the land as space would still be available.

Contrast the tax on capital goods. An annual tax of 2 to 4 percent a year on the full current worth of buildings —the capital value, not the annual income—is a heavy tax. It must be highly "anti social," an evil force which has crept up on a largely uninformed public by gradual stages. New, well-constructed, high-quality buildings are taxed more heavily per unit of space than are poorly constructed, low-quality buildings. The kinds of properties that are most desirable are hit far more heavily per cubic foot than slums. The incentives are perverse.

Is it not high folly to require that a family or a company which supplies more capital facilities and thus enhances the quality of life in a community must for that reason also pay more toward the cost of government? Such burden discriminations can hardly be justified by the cost differences which the two types of property and their occupancy (per unit of occupied space) impose on local government. Is it not more probable that run-down and less heavily taxed buildings will be associated with higher governmental costs (per unit of usable space)? When the tax is greater because the building is better, the private owner does not get correspondingly more or better governmental services. The family or the business wishing to improve by switching from poorer to better quality housing or business property cannot do so without paying more toward the cost of government—for no obvious improvement of the schools and other services it will receive.

Do American cities have a sort of death wish? High property taxes on man-made capital help to make such a "wish" a reality. Cities which urgently need to replace obsolete, decayed, degrading buildings nevertheless put tax impediments in the way of replacing them. And inflation raises dollar figures. Our lawmakers have not voted openly to say, "Let us penalize by high taxes the remedy for some of our urban troubles—new investment in high-quality structures." But such results come about.

Lawmakers and "ordinary" people who are concerned about their own economic well-being—and that of their children, their neighbors, and other youth—should recognize the crucial importance of business capital. Good jobs rest upon capital facilities in large amounts. Employers can hire and pay wages only if there is output for sale above cost. One cost is property taxation. At present prices, a good job can require physical capital—buildings, machinery, utilities, computers, inventory—of $40,000 per person. If the locality imposes an effective property tax rate of 3 percent, then the annual property tax bill on capital per worker will be $1,200. (Some rates are significantly above 3 percent.) If the tax rate is one percent, the annual tax will be $400. Inflationary increases in construction and machinery costs can make the differences even larger. As one contemplates a future with perhaps considerable inflation, will there not be even more wisdom in reducing tax reliance on man-made capital and looking to site values?

The tax element on newer—and better-quality—housing would go down. This force would increase the attractiveness of buildings as an investment. Any present differential favoring obsolete and slum building would decline. Market processes would work faster to replace old buildings and machinery.

Considerations of equity are cited to reenforce the proposals here. Gradual raising of taxes on land would work against present owners, but they would benefit from cutting taxes on buildings. Assuming no change in total revenues, essentially equal offsets in the transition stages would be frequent.

Advocates of shifting emphasis to site values often emphasize potential merits in the pressure that would result to put land to higher and better use. The effects in older urban areas would vary from one place to another. Space limits do not permit discussion of the issues except to note that some owners, especially of vacant land, would be able to take advantage of the improvement in prospects for good returns from new capital. They could build structures that make beneficial use of their land sooner than otherwise.

Where land values go up, landowners would get less of the "unearned increment." The local treasury would get more. More of the socially created values would go for governmental, rather than private, uses. The localities doing the most to make themselves attractive could count on revenues resulting from the higher values of land. □

Footnotes:

[1]One feature of fairness associates tax burdens with benefits received. It is fair to pay for what one gets and not to enjoy a "free ride" at someone else's expense. By this concept it is not fair to use the coercive power of government (voting) to impose the cost of what one gets on other taxpayers. In both the making of decisions and the results, fairness of this type is evident from one community to another (not necessarily families within communities) as property taxation does adjust the payments for different quantities of services to local burdens. Generally, the localities in which burdens are highest are those providing residents the most services. Here is an element of justice in a quid pro quo sense. Property taxation ranks also high as a means of achieving equity in another form—capturing some "socially created" values.

[2]Families that bought homes in the 1950s with mortgages for a large fraction of the total price and interest rates from 5 to 6 percent have often reaped handsome dollar benefits as house prices have risen. The lender—often a depositor in a thrift institution—suffered increasingly as the fixed interest lost purchasing power. Eventually, the dollars received fell below a year's depreciation of the worth of his capital. Whatever the increase in property tax, the net position of the family which purchased a mortgage years ago compares favorably with that of the lender. Today, home-mortgage interest rates above 9 percent take some account of prospective inflation. No one knows what the future holds, but participants in the market place act on the information available.

[3]Of course, the recipient of the payment or one of his predecessors may have invested money and effort in making the land and the neighborhood more desirable. A part of what present users pay will represent compensation for such efforts and should be recognized to the extent feasible as man-made capital. Most land, however, brings a price that exceeds the worth of such inputs, perhaps by a large multiple.

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