It's Time to Equalize The Load on Workhorse Of Local Finance

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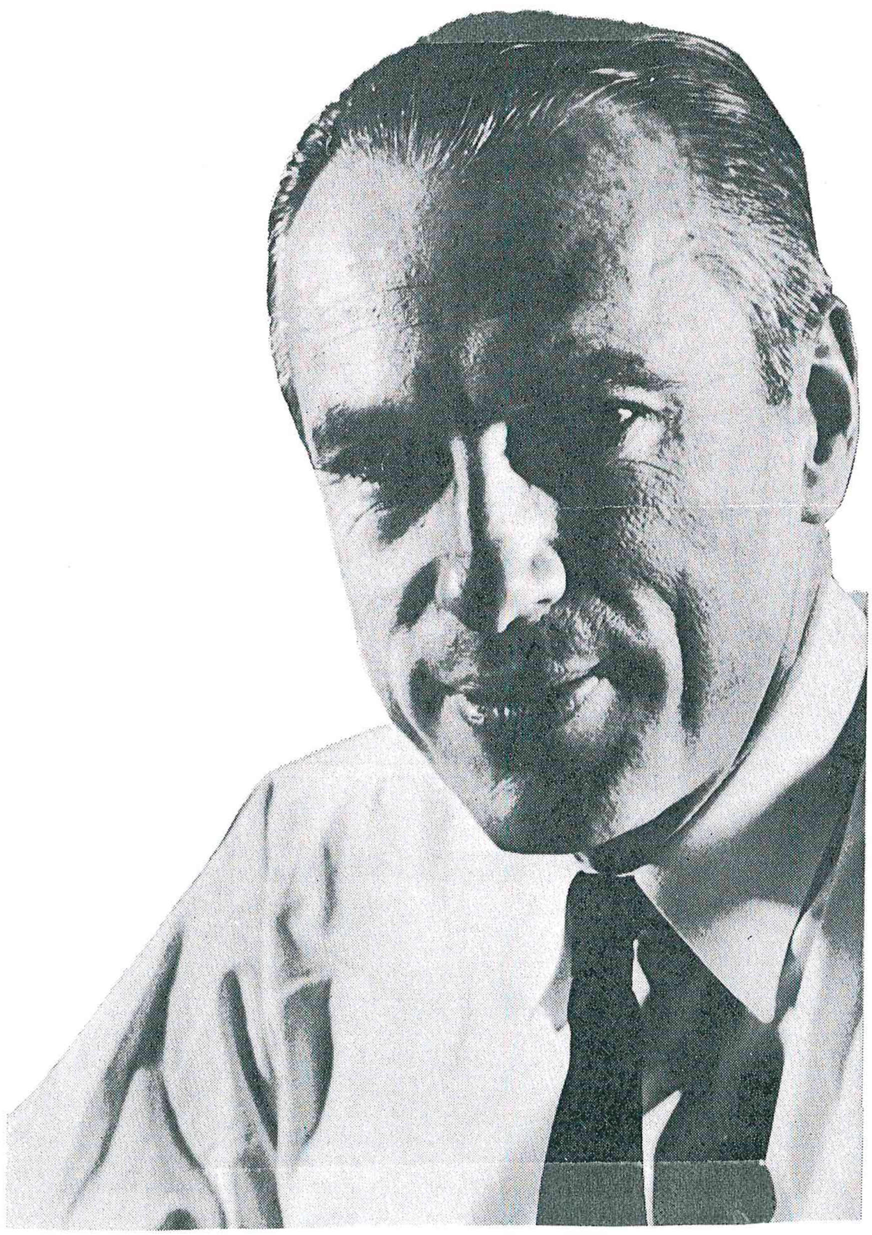

HOW FOOLISH CAN we get and remain?"

"Plenty." For example, is it not really stupid to compel higher taxes when a junky old building is replaced by a fine, new structure? Cities and towns badly in need of capital invested in modern structures impose heavy burdens on what would be desirable and relatively much less on the old. Something must be wrong. It is. It can be changed, for the better, as part of a "package" which would maintain total revenue.

Although local expenditure pressures have outstripped the property tax, it remains a workhorse of local finance. It pulls a bigger load each year.

BENEFIT WHOLE COMMUNITY

Per capita, it rose from $117 in 1964–65 to about $175 today. In much of the country it could do even more, relative to values and to personal income. Where high or low, the tax could be reformed to the benefit of the community as a whole. Everywhere the public has a promising opportunity for the taking—the possibility of bringing property tax revenue with substantially fewer adverse effects than at present, and with some good positive benefits.

For example, in nine of the 38 most populous standard metropolitan statistical areas, per capita property tax was over $210 (1968–69). The average was $188. But in 16 areas it was less than $150. According to Tax Foundation, Inc., "Facts and Figures on Government Finance." In nine States for all governments the average was less than half of the national average of $152 per capita. Perhaps an even more revealing measure relates property tax to personal income. Per $1,000 of personal income, the property tax averaged $45 in 1968–69; (the median State was $44). In 18 States it was under $35. In 11 it was over $55. Many areas do utilize the tax less fully than is generally accepted in other areas.

PROPERTY TAX UNEXPLOITED?

Heavier reliance on land values as a revenue source offers a substantial opportunity to local governments. Municipal finance officers may, or may not, be fully aware of the extent to which land prices have risen. Few officials are likely to realize how greatly the funds they have been spending for the community have contributed to the rise in land values.

Any suggestion that the property tax is not used to its fullest potential will strike many observers as nonsense. Be that as it may, reference to certain basic economic realities of taxation can show the way to constructive reform. Better, and in some cases more lucrative, use can be made of this revenue source.

First, however, a credo; Property taxation has a major part to play in the viability of local government as an independent force in our society. Communities can utilize this source to finance programs, and kinds of performance, which differ from those of neighbors. Community individuality, difference, experimentation, autonomy, all these can be aided by strong local finance resting on property taxation.

But as the tax now exists, it needs modernization—over and above reform of administration where that is poor. The basic reconstruction would shift much of the burden from the values of structures to those of land.

Alert local officials probably sense that some of the expenditures which so strain municipal budgets have helped to raise land prices. Private owners have captured much of the benefit. But such results are not decreed by immutable law. More of the private gains could properly be used to finance local government.

TWO TAXES, NOT ONE

Economically, "the" tax is two. This fundamental economic fact should guide actions. A long evolution of property taxation in this country has blended significantly different elements.

One consists of tax on land—location or site values. The other falls on buildings, machinery, and other wealth created by man. In an economic sense, the property tax is two levies. The differences are of profound significance.

Wise local tax policy will make a deliberate effort to restructure the property tax to take account of its differences. Setting aside the fact that such modification would generally require revision of State laws (even constitutions), let us examine what is involved.

The proposal has two parts.

One offers a positive opportunity for strengthening the finances of local government by drawing more upon socially created values of land. The other promises relief from the adverse effects of the tax on improvements; these load the community with "excess burdens," unnecessary losses of well being which result from the way that suppliers of capital for buildings and owners of property, alter actions as a result of the tax.

NOT WEALTH OR INCOME TAX

The property tax is not a tax on net wealth in any meaningful sense. It should not be thought of as attempting to burden people according to their net worth. This is not its nature. Nor is the tax one on income. As a rule, of course, we do pay the tax out of the flow of income, partly in the open, partly as hidden in the prices of things we buy. The amount of tax we pay, however, bears no necessary relation to income. We should not try to evaluate the property tax on the criteria appropriate for income taxation.

REGRESSIVE?

Although one frequently sees condemnation of property taxation as being regressive, the facts are not so clear. The lowest income groups, for example, are not as a rule owners of much real estate. The property tax they pay is that shifted to them in public utility charges, the consumer items they buy, and, especially in housing rents. On the whole, over most of the public, the burden appears to be more nearly proportional. But rather more than an average load will probably fall on larger owners of property.

Although when expressed as percentages property tax rates are small numbers, they apply to capital values. In parts of the country, but not all, they are "high." Comparison with rates of income or sales taxes will often be deceiving. For example, a 3% property tax equals 33% of the pretax net income—and 50% of that after tax—from a property which yields 6% to the owner. The tax frequently exceeds 25% when expressed on the same basis as a retail sales tax.

At such levels any tax will have non-revenue results. So let us look at some of the effects other than revenue. Doing so will lay the ground for understanding the reform which offers positive hope—substantial reduction on tax rates on buildings and other improvements and higher rates on land to make up the revenue.

TAX EFFECTS ON STRUCTURES

Heavy taxation of buildings accounts for some of the deplorable features of our communities. The tax hits well-constructed, high-quality buildings far more heavily per unit of floor space or cubic content than does the tax on slums and "junk."

The element of property taxation which falls on buildings creates an incentive against upgrading quality. This influence is especially undesirable in those parts of cities where construction needs are urgent and tax rates are high. Such discouragement of private effort to raise the general quality of improvements does not come from the tax on land. Quite the opposite.

Every decision involving the construction, expansion, improvement, modernization, or demolition of buildings must be weighed against the tax results. The heavier the tax on structures, the fewer the number of construction projects—and the smaller the number of dollars put into each of those undertaken—which will yield a satisfactory after-tax return. Lowering the tax rate would boost the expectations of benefiting from investment in housing and other types of buildings.

INVITATION TO DECLINE

Without deliberate intention, our present system favors buildings that produce bad neighborhood effects. The owner of dilapidated structures—residential, commercial, industrial — is freer from economic pressure to replace them with something better when the tax goes down because the building gets worse. Any individual or business wishing to shift to the 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 the better facilities themselves.

Cities that urgently need to replace obsolete buildings rely heavily on a tax which creates a bias against replacement. The land portion, however, imposes no such obstacle.

When an owner's tax bill goes up because he has constructed a better building, he does not get correspondingly more or better governmental services. His investment, however, will usually produce advantages for others around.

As compared with the old, deteriorated property, the new, high-quality building will bring positive "neighborhood benefits" to the broader public. Tragically, however, property taxation on buildings creates incentives that discourage the new. Yet we have available a partner—the tax on land—which can create incentives for improving communities.

TAXES AND MAINTENANCE

The quality of space within buildings—for work and living and recreation—will depend greatly upon the maintenance of older buildings. Under-maintenance is one way by which an owner can reduce his net investment. Any letting a building run down, unfortunately, will hurt the larger neighborhood. Deterioration of a minority of buildings can damage a considerable area. Contrariwise, good maintenance can be combined with spending for improvements which have "spill over" benefits for the neighborhood.

Property taxation as it applies to buildings has some influences on maintenance—adverse influences:

- The tax reduces the net return from the structures and thus the attractiveness of putting more dollars into such properties.
- Dollars paid to the local treasury are not available to finance maintenance.
- The owner may fear that a repair and maintenance job which has visible results will bring an assessment increase, and he will worry about a real risk that the change may be inappropriately large.

EFFECT ON PRICE—BUILDINGS

The tax on buildings adds to the cost of supplying housing, factories, utilities, and other productive facilities. Whether for renter or owner-occupant, the price of housing includes the tax on the building.

A consumption tax of 25% to 30% or more on housing will exert forces, some hidden, which affect decisions. For one thing, the tax will reduce the amount demanded, both quantity and quality.

One effect of this result is a hidden, or what economists call an "excess," burden. The tax on buildings deprives the consumer of more real benefit than the dollars paid to government. For example, within considerable limits, the cost per cubic foot of construction declines as the size of the house, apartment, office, or other unit increases.

The tax on structures, however, creates pressure for building smaller units, with less of what we really want in living space and amenities per unit of labor and materials used in construction. In terms of one of the major things generally desired — cubic contents — unit cost drops as room size increases.

One estimate finds that if the cost per cubic foot of a more or less typical, good quality, single family residence of 1,000 square feet in 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% higher for a 700-foot unit, and 20% less for one of 1,400 square feet.

LARGE UNITS, NOT SMALL

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 to smaller, size.

Resource allocation in the economic sense will be more efficient when labor and raw materials 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 imposes needless sacrifices of well being.

Not observably from one year to the next but unobtrusively and mixed with many changes occurring 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 as 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.

High taxes on buildings and other improvements have other effects. But enough has been said, I submit, to indicate the desirability of reducing the tax rates — if the revenue can be up in other ways. It can. Shifting much of the burden to land offers one means. And such a change would create forces which would have desirable non-revenue results.

THE PROPOSALS

Land would be the base for much more of the property tax than it is today, while improvements would occasion much less tax. The relation of the rate of land to that on buildings might be 3 to 1 or 5 to 1.

Greater use of special assessments would also seem wise though absence of deductibility for income tax purposes now exerts a bias against them.

A somewhat new form of tax on urban land might well appear. It would use such elements as plot area and location to determine some of the tax due, and set the amount objectively according to features readily measurable.

One result would be to reduce the weight placed on value alone. Another would be to relate tax more to the cost of providing certain services—streets, sewers, sanitation, fire protection — especially those at different distances from centers.

MORE INVESTMENT IN NEW

A cut of half or two thirds in the tax rate on buildings, machinery and other reproducible wealth would reduce the ill effects of the present system. The tax relief for junky, slummy, old buildings would be slight. For fine, new structures, the benefits could be appreciable.

Lowering the tax on buildings (an operating expense) would increase the attractiveness of such investment. The competitive position of building in the demand for capital funds would rise. In the competition for new capital funds, the first communities to shift toward site-value taxation — more on land, less on structures — would have an impressive advantage over those coming later.

Market processes would work to replace the old with new. The mighty forces of private enterprise — decentralized, partially obscure, dispersed — would work more vigorously. The results cannot be predicted in detail — which building, where, of what type. In general, however, the consequences can be foreseen with confidence.

Slums would not all be replaced by modern structures before the next election; but the process of replacement would be accelerated. Non-tax obstacles to the rebuilding of older cities and the construction of new are numerous. All the more reason, therefore, to reduce the present property tax obstacle.

Modernization and maintenance would become somewhat more attractive as a use of capital. The average quality of the community's stock of buildings would improve.

Gradually, users—owner-occupants or renters — would get better accommodations per dollar of cost. Less of what they would pay for the use of the building would go to support government. Consequently, each dollar would buy better quality, larger quantity, or some combination.

SHIFTING BURDEN TO LAND

Incredible as it may seem, property taxation has an almost happy prospect. 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.

A change in the framework of the economy can alter — improve — the environment in which men carry on their activities. The incentive system being altered, the results of the myriads of private decisions will conform to a better pattern of resource allocation.

Three distinguishable, albeit related, prospects support proposals for substantially greater reliance first on land as a tax base, secondly, justice, progress, and efficiency.

(1) **Justice and Equity in Sharing Costs of Government.** Much of what people pay for the use of land — "the original and indestructible qualities" — will reflect socially created demand. Much of the cost of land to the user is not a payment to bring land into existence. The community can capture in taxes some of the values which it has created — including values resulting from local government spending on streets, schools, and other facilities. In this "most just" manner the community can get funds to pay for local government.

(2) **Progress. Relief of taxes on structures** would result from the enlarged revenue from land. Adverse effects like those just described would be mitigated.

(3) **Efficiency in Land Use.** Higher land taxes would put greater pressure for the fuller and better use of land. A more efficient market in land would facilitate more productive use of this immensely important resource.

A high tax which is in force for long will do one thing, reduce the quantity of that thing — with one exception, a high tax on land. Nature made land (in its natural state), lots of it; but nature has not charged us for it. With only rather few exceptions, land has not come into existence because someone paid to get it produced. Yet for some land we pay a very high price. When we do so, the Creator does not get the generous payment.

CHANGING THE LAND

Perhaps the person who gets what we pay, and prior owners through history, will have invested money and effort in changing the land from its natural estate and in improving the neighborhood. In such cases, something of what present users pay will represent compensation for an investment of capital which is economically similar to capital investment in buildings. Most urban land, however, brings prices which are vastly greater than the worth of inputs of owners for making the land and location more desirable (including what they have paid in land tax for development, of local capital facilities and current services).

The amount paid now, whether capital value or annual rental, generally exceeds, by a large amount, whatever was needed to get land in its present state. What city today has more land (within the same boundaries) because the average price which people must now pay is three or four or more times that of a generation ago?

If more, the payments for land, beginning before or with Henry George's publication of "Progress and Poverty" or a generation ago, had been channeled into the local government treasury, other taxes could have been very much lower. But the land as space would still be with us. In the case of land — but nothing else — price does not determine the amount to be produced.

Price, however, does have an economic function other than getting things produced, and a very important one. That other function consists of guiding the use of land, of preventing waste in consumption, of allocating resources according to their relative productivities and scarcities.

A "high" price for some land is essential for guiding it to the best available uses. A good market in land, one built around prices, is of the greatest importance in getting the most productive use of something we must all have space.

For things other than land, "higher" price not only restricts use — guiding, allocating, apportioning.

Price also encourages and pays for more (or less) new output. Not so for land. To assure efficient allocation, the user must pay; but the owner need not receive all that is paid. Therefore, government can step in and take quite a chunk of what the user pays, with no harm to the supply of land in existence nor the pressures and incentives for efficiency in use. But not take all, not by any means. An owner must feel confidence that his cunning and effort in finding a use yielding more return will bring him benefit.

By substantially increasing the land tax, government would make a change in the condition of land ownership. The total yield, the gross income collected from users, would not change. Private owners would get less. The public would get more. The price system would still allocate land use.

CAPITALIZATION

The tax on land makes for a lower price. If tax is increased, the amount remaining for the owner drops. The price a buyer will pay goes down as government's taxes rise. The user pays no less for each year's use, but government through taxes pre-empts more.

In this way, property taxes on land are "capitalized." They reduce the price which a buyer will pay. Thereafter, the user (buyer) of the land turns over, in effect, a part of the yield or produce to government. Ownership is worth less.

But the person who has purchased after the tax became effective does not suffer from it. He who owns the land when the tax rate is raised "pays" the tax increase in perpetuity. In practice, what he fails to get may be only a portion of what would be a rise due to social change.

But higher land taxes which permit lower taxes on buildings will tend to encourage construction and in doing so raise the demand for land. Therefore, the actual decline in land prices may be less than originally expected —or in some case it may not occur.

EASING OF FINANCING

A tax increase on land reduces its price but not, we assume, the total costs of ownership. A purchaser will pay less in price after land tax has been raised. But he will then pay more each year as tax.

It might seem that the position of the new buyer will not really be any different—less interest but more tax to pay each year. In another respect, however, buyers will be in a better position.

The change would favor the person with less capital. Because price is lower a buyer could acquire land with a smaller outlay; he would need less of his own resources and less borrowing. More buyers would have a chance to acquire land. The annual charges for interest plus loan amortization would be less, but the owner would have to pay more to government out of each year's gross yield.

Individuals or real estate enterprises, such as builders of apartment houses, who are "short" of capital relative to opportunities for good use of investment funds for buildings—that is, men with vision and willingness to risk but short of funds—would find conditions of borrowing easier.

Builders could proceed more rapidly, not only because the prospective net return from investment in new buildings would benefit from the decline in tax but also because land cost would absorb less of the available capital, including borrowing power. More people would be effectively in the market for supplying buildings.

JUSTICE OF VALUES

Raising taxes on the existing capital value of land would generally work against present owner's of land. Values of existing buildings, however, would tend to rise with the drop in tax rate on improvements. For the great majority of cases in the short run, much of the effect on land prices would be offset by higher building values. The average owner's position would not change by enough to warrant concern in a world with constant change.

For owners of land having little in the way of improvements (little in value though perhaps quite a bit of space in an obsolete building), losses (from present values) would sometimes be more than nominal.

Yet some owners of vacant land might come off surprisingly well because they would be in a position to take quick advantage of the new conditions and build structures to make more intensive use of land.

Where losses do result, the justice of such change would be anything but obvious and to most ways of thinking probably not easily defended. One can properly argue, however, that society owes nothing to the owner who has kept land out of use or below its potential. Withholding of a resource scarcely seems to justify compensation. Still, changing the "rules of the game" must not be done without regard for implied as well as explicit commitments.

CHANGING THE GAME RULES

For the immediate transition let us assume that some adjustment will ease the more extreme cases. Chief emphasis will be prospective, on future value increases. In a society with large population increase and rising income, land prices seem certain to go up over time, even without general inflation.

Moreover, as a matter of permanent policy, investments by owner (or tenant) in improving land and location values ought to be treated as inputs of capital. To the extent practicable, such inputs deserve the same tax consideration as investment in structures. Certainly, public policy ought not to discourage outlays for clearing, draining, landscaping, and other forms of investment involving land.

Over the longer run, present and future landowners would get less of the increment in land values. The general public would get more to pay for costs of government. On this score, the equity results commend themselves very strongly indeed.

Socially created values would go for governmental rather than for private uses. The absorption of increments of land values for local, rather than State or national, governmental use would relate government financing to a benefit basis geographically. The localities doing most to make themselves attractive would have most of this revenue source.

In major cities $10,000 to $15,000 of governmental outlay is often needed for each new dwelling unit — schools, s.reets, fire and police, sanitation and health, park and prison facilities. Under present arrangements much of the benefit from such outlays accrues to the owner of land; his payment toward the cost will generally be only a modest portion of the total.

MORE TAX, LESS BURDEN

As for the future, the tax on land values above their present levels would be almost burdensomeless. Owners of land and their heirs would get less "unearned increment" from rising values. Where market forces cause land values to drop, and in some communities declines will occur, the annual tax would decline.

No other revenues source can compare on this score of fairness. Future taxpayers would be no worse off for the much heavier tax they would pay on land. The purchase price of land would be correspondingly less. Who would be less off? Only landowners and their heirs who would otherwise have gotten unearned increments.

More of the rise in land values which results from (1) governmental investment in community facilities; and (2) the general rise in demand due to the growth of population and income would go to pay for the costs of local government. Such a tax on a pure economic surplus seems as fair and as equitable as any imaginable source of funds for financial local government.

The National Douglas Commission on Urban Problems estimated that in the 10 years to 1966 land prices rose by over $5,000 per American family—over $250 billion (in spite of rising taxes and interest rates). If only half of this amount had been used for local government, a large reduction of the burden on buildings would have been possible. The rise in land prices did not end in 1966.

FOR A BETTER USE OF LAND

The necessity of paying tax, in cash, at "high" rates, on current market value of land would intensify pressure on the owner to get the best income possible. Heavier tax would sometimes force owners to make more effective use of land. The "speculator" would face new conditions, generally increasing the inducements to put land—sites—to a use more nearly up to that which market demand suggests as most productive.

Today, keeping urban and suburban land idle, or nearly so, while waiting for the price to go up may cost rather little. An owner's ability to deduct property tax in computing taxable income reduces the net cost to him—but not to society—of holding land largely idle waiting for the price to go up.

If the assessor "cooperates" by putting lower figures (relative to full value) than for developed property, the public official is compelled to work against the public interest. He probably does so without realizing the deeper implications of the under-assessment. Users of other land must pay more when under-assessment and under-taxation of some land helps to keep it under-utilized.

THE BITTER FRUIT OF HOLD-OUT

Where land is held out of the "highest and best" potential use for whatever reason—ignorance, lethargy, or desire for future capital gain from community growth and development—a heavy tax payable in cash will add inducement to find and adopt a type of use which will bring more income, now rather than later.

At present an owner can keep a resource created by nature (plus governmental outlays for community facilities) from being used, or used to best advantage. The higher land tax would reduce such possibilities. The economics of slum properties and seriously deteriorated structures—all aspects of the economics of land use in run-down areas of cities would need re-examination.

With reduction of the tax on buildings, especially new ones, conditions for putting land to better use would improve. Both the "negative" aspect of higher land tax and the "positive" element of lower burdens on new buildings would aid replacement. Over the long run, one effect of lower taxes on improvements would be to encourage earlier replacement.

As a result of the higher tax on land, the withholding of land from "better" use—commonly called "speculation"—would become more obviously expensive.

The market in land would tend to be more active with more units favorable for sale. Assembly of larger units and greater opportunity for subdivision and use of parcels of different size should both be accomplished more readily.

In a dynamic society, one with endless forces of flux and change, public welfare will be served more effectively the greater the freedom to change land use, to adapt as conditions change.

AN URBAN URGENCY

A reason for urgency in shifting to much greater emphasis on land as the tax base stems from a feeling that emerging public concern with urban problems will lead to programs of special aid for cities. Some aids will be outright subsidies, some may be tax concessions. Whatever the form, one prospect must be recognized: Programs of urban aid which direct funds into particular areas will tend to raise land prices there. Will not much of the intended benefit then be incorporated into gains for landowners? Experience indicates a "yes" answer.

America's expensive farm programs have seen subsidies capitalized into higher land prices to the benefit of owners of land at the time the plans became effective. Later users of farm land must pay more and to this extent get no benefit from the subsidy.

The same sort of thing must be expected in urban aid unless special precautions are taken. Economic analysis and experience teach: future residents and other users will get less advantage from urban subsidies and aids than is intended to the extent that land prices absorb the worth of special aid. And one project's success by raising nearby property values will add to the cost of other projects in the neighborhood.

Finally, as private and governmental outlays to improve the environment produce results, will not owners of land nearby, and downstream and downwind, get unearned increments? Greater reliance upon land as a source of finance for local governments would enable the general public to capture some of such values to help pay for public services.

Lower taxes on buildings offset by higher burdens on land, this basic reform of property taxation, offers many benefits, to ourselves and to our children and grandchildren.

Is it fair, is it consistent with the principles of free enterprise capitalism, to exert such pressure on the owner of property? Whatever one may feel about government pressures on property use in general, land does differ in vital respects. For one thing, the owner did not create the land.

His moral claim to any reward (net after tax) for just owning the land he did nothing to bring into existence, such claim seems less than impressive. Decisions about land use will affect not only the owner and his tenants. The decisions also affect people around and those who may have to "leap-frog" or use more of their life traveling farther for each day's work if he keeps the land at a use which is below optimum for the community. Does any individual really have a "right" to impose higher costs upon others? ■