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Opportunities for Property Tax Improvement

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Governments today cost a great deal and they cost even more than one sees!

We can observe the totals of taxes, fees, and other such payments, but such figures do not measure the total in full. People sacrifice more than the funds paid to tax collectors, because taxation induces changes in behavior. These changes almost always result in less employment and production, which results in less to be consumed and a lower standard of living.

In voluntary exchange in markets there is a *quid pro quo.* But where taxes are involved, an individual gets neither more nor less service if he or she pays more or less tax. Sometimes to save on taxes, it is better for the taxpayer to arrange affairs and to accept results that in a fundamental sense are second- or third-choice. There is real loss in that the resources could have been used to better advantage. There is an "excess" burden that is real but largely hidden.

If we do not pay for gasoline, we do not get it. But if as individuals or businesses we do not pay a tax, we shall probably get no less in government service. Incentives to try to escape some or all of a tax are real and often powerful. A family or a business may find it worthwhile to take what in terms of real productivity is a second- or third-best alternative. The taxpayer ("tax-escaper") loses something—and the government does not get what is thus lost. The economy operates less productively—people have less real income—than otherwise obtainable.

In other words, actions to reduce the tax bill—we make them often—divert us from opportunities that would otherwise be preferable. To illustrate, consider a possible action that would produce 20 and require a tax of four (20 percent), leaving 16 *vs*. another possibility that would produce 18 but would only require a tax of one, leaving 17. A person or a business would be better off choosing the second-best alternative but society would suffer because production is smaller by two. That loss reflects behavior changes induced by taxes and is often called the "dead-weight" burden of taxation. In the first instance, government treasuries get the four that the taxpayer loses. In the second situation, however, no one gets the two that is not produced. The public as a whole suffers twice—the loss of funds for government treasuries and the loss of output that could be produced.

The cost of taxation, therefore is not only the amount paid to the tax collector, but also the transactions that do not take place because taxation renders them uneconomic. Such losses are rarely observable. They are not included when one tries to compute the full expense of government. The dead-weight losses which an economy suffers will depend, among other things, upon the height of tax rates (the incentive to escape tax) and the availability of alternatives.

Individuals subject to high marginal income tax rates on earnings have a readily accessible alterna-

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tive—leisure. Shorter workweeks, longer vacations, earlier retirement. The persons subject to high marginal income tax rates will tend to be persons whose efforts are most valuable as measured in the market. How much loss of the very good does society suffer from high income-tax rates? No one knows.

For most taxes the alternative may not be so obvious nor so readily available as the choice of some leisure over some additional after-tax income. In the instance of property taxation, a person can choose not to build at all or to build a low-quality structure. Investors have alternatives for the direction of new capital. Capital can be directed to areas where tax rates are enough lower to justify the sacrifice of some earnings potential.

In the United States, the physical structures of housing, the production facilities of manufacturing and electric power provision, of transportation and communication, of commerce and trade and finance, of agriculture, and other tangible property are subject to property taxation. Decisions to preserve, to maintain, to improve, and to expand must allow for property taxes. And in relation to the worth of what the properties produce, the taxes each year are significant. In contrast to say, a one-time sales tax paid at the time of purchase, taxes on property will be levied year after year.

Although we seldom see how property owners react to costs for which they get no saleable product, it should be evident that property taxation will make an economy's stock of physical capital, adjusting for quality, smaller than if taxes did not exist or were lower.

Economically, Two Levies, Not One

To understand the potential for improving the property-tax structure, one needs to understand a central reality: In an economic sense, "the" property tax base ordinarily consists of two quite different elements—(1) land and other products of nature and (2) buildings, machinery, and other things men and women have produced.

Whether in agricultural or urban areas, the land element differs significantly from man-made capital.

To a business or an individual, a farmer or a homeowner, an investment in land may seem much the same as one in buildings or machinery. No reason to distinguish. But for persons concerned about the economy, national or local, the difference is profound. The viewpoint that is appropriate for the businessman or the builder will not include elements that have vast importance for public policy.

To repeat: the property tax (in the United States and usually elsewhere) is in an economic sense not one but two taxes. One part falls on man-made capital—buildings, machinery, and so on whose quantity, nature, and location differ beyond our ability to comprehend. The other part falls on land as nature created it—essentially fixed.

Property taxation of buildings and other man-made capital falls on things that are subject to change as human beings respond to conditions. At any one time, of course, past decisions about where and what to build limit what can be done. But owners and builders do have alternatives.

New, well-constructed, high-quality buildings are taxed more heavily per unit of space than are slums and "junk." In many areas new machines are taxed more heavily than old. Is it not stupid for society to decree that if a family or a company supplies more and better capital facilities it must also pay more toward the costs of government? Can justification for such discrimination be found in the cost difference which the two types of property impose on local government (per unit of occupied space or machine used)? Probably not.

Moreover, the tax on buildings discourages maintenance and modernization.

American cities, where the replacement of obsolete and dilapidated buildings is all too often long overdue, nevertheless put tax impediments in the way of progress. No one tried deliberately to base local finance on a tax that favors holding on to the decrepit structures, while penalizing the new. But the person who wishes to shift from poorer to better quality housing, or business structures, cannot do so without also paying more toward the costs of government. Is this perversity not both irrational and self-defeating? The tax on buildings penalizes the kind of human actions which will benefit human beings without imposing extra costs on government.

The American property tax on buildings produces a rarely recognized "excess burden." Taxes on structures as a cost of occupancy will tend to induce, among other things, smaller size rooms. We lose potential benefit. The expense per cubic foot of construction declines as the size of the house, office, display area, apartment, or other unit increases (within varying limits). In terms of one of the major things generally desired—cubic content—unit cost drops as room size rises. Content increases more than proportionally 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. Human well-being can be served better (within eventual limits) by the construction of rooms of larger, as opposed to smaller, size.

Land Differs

Land as a factor of production in its original form differs from capital and from labor. Moreover, each parcel of land differs from all others, at least as to its location. Without straining to note similarities and differences of the factors of production, let us cite a few characteristics of land that are significant for structuring a tax system:

1) Each parcel of land is unique as to its location.

2) The total quantity is fixed (with limited exceptions as to the possibility of increase or destruction).

3) Land is immobile.

4) In buying or leasing land for use, what one pays does not go to create the thing (parcel of land) to be used.

5) Land is eternal or is so nearly so that decisions that are appropriate can involve very long periods.

6) The use of a parcel typically requires labor and capital often with commitments for long periods.

7) Land cannot be hidden.

8) Special bodies of law and regulation affect the ownership and use of land. Such laws can differ significantly from one place to another.

9) The worth of parcels of land depends greatly upon conditions around them and on the actions of others (neighbors).

10) Over the decades "unearned increments" of land value have accrued to owners.

11) Much of the economy's non-governmental debt rests upon pledges of land.

12) Benefits from land are often received "in kind"—from being used directly (e.g., by a homeowner)—without current cash payment.

13) Over centuries, and throughout the world, the conditions of land ownership and occupancy have exerted great influence on societies.

14) The values today of portions of the earth's surface often include the results of investment of capital and labor.

Land *does* have features that distinguish it from labor and capital as productive resources or as used for consumption.

Property Tax Revision: Short- and Longer-Run

Adverse non-revenue effects of taxes can be reduced by achievable revisions of property taxation. The conclusions that I propose stem, most directly, from knowledge of conditions in the United States. But some potentials are, I believe, universal rather than merely American.

In the short run, reductions in tax rates on improvements could be financed by increases in revenue from taxes on land. Gradually, more and better man-made capital would become available to serve the people in communities making such changes.

For the longer run, i.e., over decades, more of the total financing of government could come from pure land rents. Income, business, and consumption tax rates could be reduced—at some margins by relatively large amounts. The distorting effects, the dead-weight losses, of taxes on labor and capital would decline.

How great are such losses to society? No one can know. But we do know that business decisions reflect tax considerations which can be quite remote from the realities of producing and consuming.

What I propose is to use more of land rents to pay for government. Not an original insight. The Physiocrats in France more than two centuries ago had the same idea.

The Meaning of "Rent"

Rent differs from wages, interest, and profit in ways significant for taxation.

The term "rent" is used with a variety of meanings. Someone may rent a tuxedo or a car or an apartment or a farm. Generally, one obtains the use of a tangible thing in exchange for payments of money—typically for a series of uses over time.

Some economists (e.g., David Ricardo) generations ago treated rent as the payment for the use of “the original and indestructible qualities of the soil.” What would be paid for the land only—as created by nature—one may call “the pure land rent.” This meaning lies at one end of a continuum that can be rather extensive. The “pure” concept as applied to land must be distinguished from actual payments that include compensation for investments that become part of the land as it is treated in the market (plus sometimes the efforts of entrepreneurs in development that changes the character of an area).

A somewhat different approach identifies rent as the amount above whatever is necessary to call a productive resource into existence and to make it available for use. The skill of an athlete, actor, or inventor may yield rent-like returns. And long-lived facilities may bring what are sometimes called quasi-rents. Mineral sources and the broadcast spectrum certainly have elements properly treated much like land for such discussions as in this essay.

Rents in the economic sense are very different indeed from the funds so labeled in national income accounts.

Uses of Land Without Payment of Rent

Much land is used by the owner—without payment of rent. Homeowners (owner-occupants) do not identify and measure periodically in money terms the worth of the land they use. The monthly mortgage payment includes funds that are economic rents. But rarely if ever does this portion of the mortgage payment get the label that characterizes its economic reality.

What the renter of a store or an apartment pays as rent ordinarily includes interest and profit for the supplier of capital, a bit for management, and something for the costs of government (taxes) billed to the owner of the property.

Many businesses own some or all of the real estate they use. The company’s accounts will not as a rule identify the pure land rental element. The imputed value of occupancy of land owned by the business will rarely if ever be shown in the accounts (as a yield of the property or as an expense of operation).

The periodic (imputable) worth of land owned by governments does not as a rule appear in financial accounts of governments.

In short, the flow of benefits from land as such will have value much in excess of what the numbers in the accounts show.

Significance for Financing Government

Pure land rents are real even though they are not identified as such. They are an economic surplus in the sense that the source, the land, would exist and would be available for use whether the payment is zero or some enormous sum. Classical economics distinguished land from other productive resources (labor and man-made facilities). And rent was distinguished from other flows of income. In some societies inequalities in land ownership have led to very great differences in income, to class distinctions, and to political power.

American economists a century ago, in their theorizing, began to blend land with capital into a single factor of production. And rent as a distinguishable form of income was more ignored than recognized.

More recently, concerns about the effects of taxation on resource allocation and economic efficiency have increased the attention paid to the unique characteristics of land and land rent.

How Much Rent?

Attempts now being made to estimate for the U.S. the total of rents on real estate (land and structures) suggest amounts around $800 billion a year. The “pure” land rent portion is somewhat less than half. Property taxes take around $200 billion of the total.

A shift, over time, of one half or so of land rent not already taken in taxes would finance a meaningful cut in tax rates on man-made capital. Of course conditions differ from place to place. Net, on average, property owners would find tax bills more or less unchanged.

Is there also a potential for financing reductions in marginal rates of other taxes, e.g., state income taxes, reductions large enough to influence behavior significantly? Perhaps—over time. Most of the flow of benefits from land goes to pay mortgage interest. Outstanding debts must be honored. Whereas the property tax restructuring just proposed would reduce taxes on man-made capital and thus give benefits to owners required to offset higher taxes on land, the use of rents to reduce top income-tax rates could, and probably would, affect taxpayers in quite unequal amounts.

Basic Economic Factors

A community putting tax on man-made capital faces the competition of other communities and of other uses of resources. The intensity of competition will vary considerably. It appears as to new commitments, new structures and machines or outlays for maintenance of older facilities. At any time the proportion of a community's stock of man-made capital subject to change is small; over the years, however, the amounts can add to a great deal.

Except as regards depreciation (allowed on structures, not on land), businesses will have little or no occasion to recognize in their decisions the economic distinction between land and buildings. Both are capital investments for the company. Nor will a homeowner have reason to make distinctions between the land and the house. For the community, however, matters are decisively different.

A community can put a high tax rate on land without fear that the land will move elsewhere—as, over time, capital funds and the location of new construction can be moved. Land cannot be hidden in Swiss banks. A tax on land will not reduce the quantity produced as can a tax on trucks or liquor.

To repeat: Getting revenue from land will not reduce the quantity. The community will not suffer hidden, dead-weight losses from the movement of land. Getting equivalent revenue from taxes on man-made capital (structures and machinery) can influence the quantity available in an area over the years. The quality of man-made capital can be poorer—when originally built or as to the adequacy of maintenance—the greater the prospective tax. People may never know how much better off they could be.

Room size will reflect the tax element in carrying cost. Amenities are subject to choice that takes account of the tax on the structure. Replacement of older buildings and business equipment will be delayed if the property tax consequences are adverse. And so on.

Land is the source of benefits, a flow that reflects what people will pay for the use of the location but *not* for the creation of the land. The amount of the flow taken in taxes will not affect the quantity of land. Buildings are a source of benefits, flows that also reflect what people will pay for the benefits. And the source of those flows does depend upon what the supplier receives. The higher the tax, the less the provider can expect to retain. Behavior will respond to expectations. And to the disadvantage of consumers! They have no way of knowing how they are disadvantaged.

Concern for development, for economic efficiency, for more nearly optimum use of resources, for quality of life—for whatever the articulation, such concern now appears in various formulations. No proposal for reform will bring the utopian state sometimes held out. But benefits can be achieved by doable restructuring of property taxation in the United States and probably elsewhere.

Governments can get revenue by basing the tax on estimates of the (annual) flow of benefits or on the capital value. The more fundamental would seem to be the flow of benefits (income) for this will be the basis for determining capital values. But choice may in fact have been determined in the past. Or if a fresh start is to be made, the practices and customs of the economy can serve: the basis most widely used in market transactions.

Further Considerations

Land taxation can be essentially evasion-proof. Land cannot be hidden. It cannot move to foreign tax havens. If the tax is not paid, government can take the land.

American states and localities now compete actively for business firms (and for an economic base generally). One element of such competition can be the offer of a property tax "holiday" or even exemption. The merits of such competition will be debated. In any case, the decisions should distinguish between the land and the building-and-machinery elements of property. Any relief for the land portion will not attract new land, will not add to the land in the local economic base; any tax reduction would bring a one-time capital gain for the present owner (for no observable productive service).

The change may cause a rise in the price of some land for another reason. The demand for land will tend to rise when lower tax rates on buildings increase their profitability and attract investment capital.

The broad outlines of constructive change can guide action in specific communities or countries. Many aspects deserve consideration. One is the effect of land taxes on the use of land. A tax that must be paid in cash puts pressure on owners to put the land to productive use—in contrast to holding it underutilized hoping for better prospects. Speculation! One aspect that warrants explicit note is that the use or lack of use of a parcel of land affects those around, close neighbors, and those who may pass by on the way to work or play.

The success of efforts for implementation depend heavily upon the quality of assessment (valuation). The worth of parcels depends upon the community, including, of course, the spending of revenues from the taxes. The price of land may in fact reflect investments by the developer so that what is deemed land is more than the "pure" land of classical economics. In setting the tax on structures, it may be desirable to reflect differences in costs imposed on the community, e.g., fire hazards. When one government owns land and other property in another jurisdiction or when nongovernmental entities receive exemption, rethinking of past practices may well be called for.

A century ago the American economist Henry George believed that all taxes on labor (production) and consumption could be abolished because the costs of government could be met by taxes on land rents—a single tax. Whatever the realities then—he was probably correct—government spending today, relative to land rents, vastly exceeds anything contemplated before World War I.

Why Have the Benefits Not Been Seized Upon?

The arguments for reducing the anti-progress taxes on structures and getting more revenue from taxes on land were made so very clear by Henry George that one asks, "Why were the opportunities not utilized long ago?" I do not know enough about the conditions of his time to presume a responsible conclusion. My guess is that much of the explanation lies in lack of active, focused support from those who would have benefited.

Most businesses, I believe, would have profited; but some, at least, were doubtless repelled by his opposition to protective tariffs and his antagonism to monopoly. His sympathy for labor unions probably aroused opposition. So did his belief that the land owned by churches should not be tax exempt.

There may have been no concentration of prospective benefits to create a "fighting" impulse in this state or that, this community or that, to mobilize decisive political pressure. Benefits would have been diffused widely—large in total but small for each voter as an individual. But even for individuals, they would have been very large over time.

Another guess is that an unduly large amount of attention was directed to the "anti-landowner" aspect and not enough to the pro-production (probusiness) aspects. And at the time other issues, e.g., gold and silver (money), monopoly, and the tariff, absorbed attention. The great potentials were those of public policy as against interests of individuals. Mobilization of support for public policy takes considerable devotion and, in a sense, self-sacrifice.

As one thinks of the enormous rise in land prices (after allowing for inflation) since Henry George's time, and dreams of the benefits for local government finance if much more of the rise had gone to paying for education, policing, and other local services, might one not say, "Let us stop the loss of opportunity?"

Alas, good ideas are not self-fulfilling. Someone must act. Human beings must make efforts. And the rewards to individuals will be overwhelmingly a sense of satisfaction, not economic benefits that help the family finances. A major shift of emphasis should be away from talking about the land-tax aspects—higher burdens on land values—and toward reducing tax burdens on man-made capital. George himself spoke eloquently of lifting crushing burdens on business. Such is a positive goal. I suggest that we make more of this.

Some years ago advocates of "supply side" economics did focus on the good results to be expected from reducing taxes on income. Rates were reduced.

The 1980s and 1990's witnessed widespread prosperity. Today at least some of the public may have considerable receptivity for the notion that human beings can and will respond positively to-tax rate reductions. Similarly they will respond negatively to tax-rate increases, *except* (as I hope I have made clear) in the instance of taxes on land.

Gradual change to absorb more land rent to help cover the costs of (local) government has great merit. It could finance reduction of the burdens on man-made capital. Getting more revenue from taxing land could reduce the real burdens of the property taxes tax structure without raising the money costs of government. Well worth the effort!

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