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Property Taxation: Modernization

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Property taxation as it exists differs tremendously from one place to another. The April *Tax Review* discussed the question, "who pays?"– looking at the country as a whole. By every measure – per person, per dollar of market value, and per $1,000 of personal income – the amounts shown varied widely. But *high* property tax rates *do* prevail in many places – and go up from year to year. In the 19 states where the 1969-70 averages (household plus business) were over $50 per $1,000 of personal income, there were whole communities, families, and companies whose affairs are affected by property taxes which are much above 6 percent of personal income. Hidden and open, such levies are high enough to exert powerful influences.

If criticism of property taxation is rising, is not much of the reason the growth of spending? Pressure for more expenditure has led to heavier use. Per capita the 1962 tax was about $140 in 1972 dollars while this year's figure may top $200.

Increases come from three sources. The first grows automatically out of new construction. Each of the other two – an increase in assessed valuation or a boost in the tax rate – requires a positive act. Either of these tax-raising actions can lead to more voter resistance than will an automatic rise in income tax from established rates which apply to rising incomes.

Perhaps some popular response to expanding government – an element on control – can be credited as a merit. Voters have opportunity to relate (1) budget proposals which will require higher taxes (2) with the desirability of more government spending. Is the ability to reject more spending and taxes a desirable element of "the good society?"

Some commentators seem to believe that any rejection of a proposal for an expansion of government spending reflects blind, retrogressive failure of voters to do something that must be wise. In fact, of course, the record shows widescale approval of local spending proposals and the necessary property tax increases.

Property taxation directly undergirds local – and, in fact, popular – government. The viability and the effectiveness of decentralized, as contrasted with centralized, government must depend upon the availability of revenue. In the property tax, local governments do have such a source. The tax can be used more or less intensively as residents wish.

Poor local assessments, a valid criticism of the tax, are not an inevitable element of local independence. The valuation job can be done by a unit of government larger than the one imposing the tax rates – the county or state. Local governments can retain authority to set tax rates.

Today's concern about property taxation raises a question to be faced forthrightly: How much conformity do "we" want to force on others – or have others force on us – by weakening a source of revenue on which voters can express themselves? Might it not be better to build a stronger property

This Issue in Brief

This second of two articles on property taxation by Dr. Harriss discusses the need and opportunity to improve the tax from the standpoint of equity and administration.

More fundamentally, he also proposes that the burden on machinery and structures be reduced while the tax on land is increased.

Finally, he discusses various new proposals to change property taxation, including the effort to give the state rather than the locality chief responsibility for the tax.

tax base to finance local services as the people directly involved prefer?[1]

Equity. Equity as a goal of public policy must be part of a reexamination of property taxation. "Equity" has several aspects.

Inequities due to bad assessment are notorious and unnecessary. Sometimes it seems that on this aspect of equity the situation is so bad as to be hopeless. Yet great improvements in administration *are* achievable, not by wishing or passing laws but by effort.

For the great majority of families and individuals the tax seems to be roughly proportional to income. The existence, and the amount, of regressivity and progressivity are uncertain. The conclusions depend, among other things, upon assumptions about (1) how much of today's tax was capitalized in lower property prices before purchase by the present owner and (2) how the tax on business and rental property may, or may not, be shifted to customers, occupants, investors, or others.

Another aspect of tax equity relates burdens to the benefits received from spending the funds. Property taxes go almost exclusively to pay for local government. From one locality to another, government expenditures differ; and so do tax burdens to pay for them. Is not equity served when the people who get the fruits of the spending are those who bear the taxes? The benefits from some local expenditure programs (perhaps welfare) may seem remote from the ownership and use of property. Others (streets, police and fire protections, parks, and city hospitals) relate more directly to the use of property in the area. For still other local spending programs there may be debate about who benefits and the portion which may go to nonresidents.

[1] An advocate of centralization — or of reducing the role of property taxation — can properly raise the issue of intercommunity competition. By granting property tax concessions (legally or outside the law), one locality can try to attract tax base (business) which will bring less in costs. Other localities, with an eye on tax revenue, may use zoning power as an attribute of local independence in ways which harm neighboring communities. The remedy for such results need not be major weakening of property taxation but direct attacks on the abuses.

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As a rule, however, will there not be an element of justice when those who are able and willing to pay more than others — those in the locality — do so by using the property tax? Differences from one locality to another in taxes paid will conform generally to differences in benefits received. The recent school finance cases imply that equality must have higher rating than in some states today. Yet even so, would it not be inequitable for state or Federal law — or judicial interpretation — to prevent people in a community from taxing their own property to spend at levels above those elsewhere?

Another dimension of tax equity grows out of the fact that the quality of local government will influence the worth of property in the area. The incentive for building better local government facilities and such intangibles as the quality of schools, and the rewards for doing so, can be related significantly to strengthening the property tax base as a foundation for financing government. Equity as *quid pro quo* can operate more efficiently on a local basis than when taxes flow into a much bigger pool from which funds then flow to areas quite out of proportion to their contributions.

Special Provisions Aid Those In Need

Search for equity leads to efforts to relieve persons in special need, and to do so without large revenue loss. One fourth of the states now grant relief to the aged. For example, homeowners and renters over age 65 with incomes under $5,000 may receive income tax rebates on a sliding scale which takes account of property tax relative to income. For renters it may be assumed that 25 percent of rent paid is property tax. If the person owes no income tax, he files a claim when he receives his property tax bill and gets cash at about the time he must pay local tax.

The details of state plans differ considerably. The costs in most cases are borne by state, not local, government. Such pinpointing of relief to achieve one form of equity can serve efficiently in the sense of benefit in relation to cost. Of course, political forces can press for extension beyond reasonable limits. For we should be cautious about "erosion" of the tax base by increasing the rolls of exempt property with the likely, but unrecognized, increase of burdens on others.

Administration. The property tax *will* continue as a *major* revenue source. It can be a *better* one. It still suffers from needlessly poor administration, in most localities remaining far below the standards appropriate to American society of the 1970's. Almost any adjective of opprobrium can be applied validly against administration as it exists somewhere. Defects of assessment are unconscionably, and inexcusably, excessive. Assessment at levels far below market prices — 20 or 40 or 60 percent —

continue, despite the long-established fact that *underassessment* exacerbates *malassessment*.

Appeals procedures do not in fact give the taxpayer effective and economical opportunity for review and possible correction of an initial assessment. Payment must often be made in a few large amounts rather than as several more convenient installments.

Fortunately, methods for improving administration have been devised, tested, and improved upon. 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. Records and other facilities are still inadequate, and preparing to take advantage of the potentials of using computers requires time.

State governments have a larger role than most are yet prepared to perform — in setting goals and standards, arranging assessing districts, training staff, supervising equalization, providing facilities for appeal, and developing innovations. Actual state participation has much to commend it. A state organization can include the varied skills required to assess specialized property. Professionalization in conjunction with reduction of the purely local influence, can help in dealing with the evils of favoritism and corruption.

More Basic Reform: Land as Distinguished from Man-Made Capital. The best administration achievable will not accomplish all that is possible in making property taxation as good a revenue source as is reasonably attainable. The pressure to reexamine offers an opportunity to restructure property taxation to take account of a major difference between (1) land and (2) man-made capital.

The quantity of land is fixed. The area will be there, regardless of almost anything governments do by taxation. This space commands prices which are often "high." To some extent these prices result from investments by the general body of taxpayers — streets and schools and other facilities — plus the demands of a growing public with rising incomes. A tax on land can capture for government uses some of the worth of what the public itself, as distinguished from the landowner, has created.

Buildings, other improvements, and machinery present a striking contrast. High taxes on such man-made capital can produce several unwelcome results. Space limits prevent analysis of the effects of an annual capital tax of, say, 4 percent or so a year. But some conclusions are clear enough to indicate reasons for trying to reduce the *nonrevenue* results of high tax rates.

The tax hits well-constructed, high-quality, buildings more heavily per unit of space than slums and "junk." The tax creates incentives against upgrading the quality of the stock of housing and business structures. It burdens the company which installs more productive machinery. When the tax bill goes up because the owner has constructed a better building or buys better machines, he does not get correspondingly better governmental services. But his investment generally has advantages for others — perhaps a residential area, or employees equipped with better "tools," or consumers.

Cities which need to replace obsolete, decaying buildings rely heavily on a tax which creates a bias against replacement. An economy which seeks higher levels of productivity puts high taxes on the essentials for progress.

Land Underassessed, Improvements Suffer

Meanwhile, quite generally land is underassessed relative to man-made capital. Sometimes it almost seems that assessments on vacant, or near-vacant land, seek to encourage speculative underuse and stimulate land price increases. Owners are under less than a "normal" economic pressure to put land to "higher and better" use. Urban sprawl forces families, businesses, and governmental bodies to incur costs which can be heavy compared with those which would be necessary with more compact land use.

Assuming that no reduction in total revenue is a realistic possibility, can property taxation be restructured to achieve better (less undesirable) effects? Yes — (1) by reducing the burden on machinery and structures and (2) raising the tax on land.

A tax increase on land would do more than "finance" a cut in the burden on buildings and production machinery. More land would be put to use which would bring larger income. The costs of speculative withholding of land from better use would become more obvious. An accompanying cut in the rate of tax on improvements and productive equipment would enlarge the ability of the locality and its businesses to attract new capital.

One step possible at once in many communities would be to raise assessments on land (while reducing, relatively, the tax on buildings). Increases in land prices in recent years have by no means been fully reflected in assessments. Local taxes have not siphoned off for the financing of local government more than a fraction of the increases in land prices which have resulted in part from expenditures by local governments.[2]

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[2] "Tax relief" policies, authorized by statute or extralegal, in various places rest upon recognition of the economic principle described here. Exemptions of new buildings (or machinery) can achieve some of the objectives on a limited scale. New man-made capital can be fully exempt, perhaps for a limited period. Or it may be partially exempt by assessing at a lower percentage of market than comparable property or by a lower tax rate. Sometimes the tax on new buildings is limited to the amount of tax on whatever they replaced.

Another possibility deserves attention – placing some tax according to elements other than value. For example, charges could be related to the costs of providing services associated with property – streets, sewers, garbage collection, and others. A more rational system of financing some of these government services would downgrade the weights attached to value.

Current Proposals for Change. Reform of the basic structure, in my opinion, would be desirable everywhere. But it has vastly greater potential in some places, such as the older cities of the North and East, than in others, such as the hundreds of small communities where effective tax rates are well below average. And achievement would take time.

Three other proposals call for comment.

1. President Nixon, and others, have suggested grants of general relief to homeowners (and renters). Such proposals have appeal – especially if the advocate ignores the question of who, then, *really* will pay the bill. In much of the country, to repeat, the amounts now levied on homeowners are much below those of the top third or so. No conceivable readjustments can possibly shift the burdens away from homeowners and renters. Who remains – vagrants, moondwellers, or sea sprites? Some additional *national* tax, perhaps a new levy on value added, would be required to help finance relief to homeowners. Whose burden would then be different? Might not taxpayers in *today's high* property tax areas be compelled to shoulder *added* burdens to help finance relief for homeowners whose property taxes are *now low*? Or the other way around? Either result might seem of questionable merit, on grounds of equity if nothing else. Or if a generally proportional value-added tax replaced a generally proportional property tax, one might ask, "So what?"

One result would *not* be a matter of indifference. Present owners would receive a windfall capital gain. Normal market forces, as indicated in the April *Tax Review*, would convert a reduction in the annual tax on real estate into higher capital values, especially prices of land. *Today's owner* would enjoy a capital gain. A buyer later, however, would have to pay a higher price for real estate. An additional capital cost, whether housing for himself or to rent to others, would offset much of the intended benefit of lower property taxes. Governments would in effect give up revenue, year after year, which to some extent had financed a rise in the price of real property. "One-shot" capital gains would fall to present owners (voters).

2. Whatever happens on a nationwide basis, in at least some states changes in school financing will alter the role of property taxation. No single pattern of rearrangement would best suit the needs of all areas, if only because conditions differ widely now. A few states may be able to substitute other revenue sources (though I am doubtful); property tax reductions would have the effects already noted.[3] New departures in using the property tax seem much more probable. State governments would reenter this tax domain after 40 years or more of leaving it to localities. Two advantages could result. But neither could be achieved quickly, nor without overcoming real obstacles.

(a) Badly needed improvement in administration could follow state assumption of taxing authority. Yet local use of the property tax could also continue, but based upon better assessments than before the state government undertook a bigger role in the administration.

(b) The revenue from large properties, such as utility and big groupings of business machinery and buildings (as distinguished from local stores and establishments) could be spread over the whole state. Would there not be a gain in equity, assuming that the tax burden rests on consumers or investors who live in an area broader than today's typical taxing jurisdiction? Some of the criticism of reliance on property taxation for financing schools would be substantially eliminated. But no sudden rearrangement of taxes now used to finance schools could come about without bad disruptions. An easier start would at first apply the statewide tax to new installations.

3. Proposals to reduce taxes on housing would probably lead to higher absolute, as well as relative, burdens on business property. In addition to short-run shocks to the companies affected there would be disadvantages to the general public. As politicians know, hidden taxes arouse less popular opposition than those which are as evident as the tax on one's house. As economists know, the bad effects of high taxes are not limited to the obvious. The areas with high burdens on business machinery and buildings will suffer in the competition for productive capital and income-producing jobs. Moreover, high taxes cannot help, and will generally hamper, the achievment of realistically obtainable efficiency in production.

Concluding Comment. Much remains to be done, and *can* be done, to make property taxation a truly strong and constructive element of the American tax system. In some respects, *e.g.*, as support for local independence and as capturing for public use some of socially created land values, I, personally, would rate property taxation high indeed on any ranking of revenue sources. In any case, our challenge is to press ahead with the many improvements necessary and possible.

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[3] A drop in the tax on man-made capital in some areas would improve the competitive position there, compared with the rest of the country. Building would then be greater than otherwise.