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PROPERTY TAXATION: EFFECTS ON LAND USE AND LOCAL GOVERNMENT REVENUES

A BACKGROUND STUDY

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3. Regressive Nature of the Property Tax

The homestead exemption and the old-age exemption do very little to ameliorate a basic and inequitable characteristic of the property tax: its regressive nature. Low-income families, whether owners or renters, spend a greater proportion of their income for housing than do higher income families. While low-income levels mean that other consumer items must be foregone, housing is a necessity however large a proportion of the family budget it may require. And taxes on housing are relatively higher than on any other consumer expenditure. The generally higher property tax rates of central city areas than of suburban areas increase the tax load for lower income residents who are concentrated in the central cities. Thus the poor carry a heavier burden of property taxes relative to their resources, than do the more affluent. Since property taxes are reflected in rent levels, this applies to renters as well as owners.

The heavy burden of taxation in relation to income has increased for nonfarm homeowners. Between 1960 and 1968 the median local residential property tax for a nonfarm homeowner property rose from 2.7 percent to an estimated 4.0 percent, and the number of homeowners paying more than 10 percent of income for property taxes rose from 1.6 million to an estimated 3.1 million, as indicated in table 7. The fact that many of the low-income homeowners are elderly, upon whom the property tax places an especially heavy burden, has led to the adoption of the previously described "circuit breaker" system in several States to provide them with some relief from property taxation.

B. INTERGOVERNMENTAL RELATIONS ASPECTS OF THE PROPERTY TAX

Revenue collected through the property tax is used for a variety of expenditures. It generally goes for the support of local services, i.e., education, transportation, sanitation, health, and welfare. In different areas it is used for different purposes. In New England general property tax revenue often pays for water and sewer services, while in many other parts of the country water and sewer services are paid for by separate "user fees" charged to the consumer. Thus, in some places a property owner is taxed on his property only once and the various local services are financed from this one collection. In other places a property owner is taxed by two, three, four, or more separate taxing authorities—a school district, a water district, a township supporting a fire department, a county supporting a hospital, etc.—each collecting revenue to maintain a particular function or service.

Since land is not depreciable and the Internal Revenue Service is likely to accept the local assessors allocation of total value between land and improvements, taxpayers may influence the local assessors, insofar as possible, to allocate more of the total value to the improvements. This tends to make for under-assessment of land.[9]

The other Federal tax benefit which more directly affects land use, is in the capital gains tax provisions. These provisions of the Federal income tax laws provide an incentive for land speculation. Profits from land held by an "investor" for 6 months or longer are subject to capital gains treatment, that is, payment of taxes on the gain realized at about one-half of his regular income tax rate. A taxpayer is an "investor" in land if he does not sell real estate in trade or business from which he derives a substantial part of his total income.

High-income persons can invest in land as individuals or as limited partners of a syndicate formed to invest in land. They may buy undeveloped land, or they may buy a farm and lease it to the previous owner or farm operator until it is sold to a developer. Not only are profits treated as capital gains, but business expenses paid while the land is owned, such as interest on the mortgage loan and taxes, which are deducted from income taxable at ordinary income tax rates, are counted as part of the capital gain, and thereby converted to income taxable at the capital gains rate. Limited partners of a syndicate are entitled to their pro rata share of the capital gain and enjoy the tax benefits as though they had been individual investors.

Land investment thus is attractive to individuals in high income brackets and also to corporations. The latter are apt to buy large acreages in the path of urban development both for their own use and for subsequent resale at a capital gain. In a study of land sale transactions during the decade of 1956–66 in the Green River Valley near Seattle, where the Boeing Co., built a few large production facilities, the author notes the following: [10]

> Although much of the land in the study area had been retransacted at least once in the interval of 1946 and 1956, parcels had remained primarily in individual legal ownerships. Beginning in the latter half of 1957, relatively large tracts of acreage were secured by corporations and railroad companies in anticipation of conversion of the study area from predominately agricultural to urban uses. This aspect of corporations purchasing land prior to the development stage in the transition of agricultural and/or vacant land may be an index as to the timing of development to urban uses. That is, when these areas are indicative of this feature of changing ownership patterns, the land can then be termed as "ripe" for development and/or the land will be held as investments—depending upon the present value to the purchaser rather than by the individual ownership who may have purchased the parcels recently or held the land for a number of years.

The land boom experience in the Seattle metropolitan area is illustrative of a process that goes on at a steadier pace in many metropolitan areas. Investors purchase suburban undeveloped or agricultural land which often may be zoned for agricultural use or single-family residential development. When the land is "ripe" it can be sold to a developer whose intention it is to have it rezoned for multi-family residential or commercial development. In anticipation of such high intensity use the investor selling the land can obtain a price which not infrequently will be 100 percent or more above the acquisition price of a few years earlier.

There is no doubt that the investor or speculator in land is looking primarily for a sharp rise in value over a short period. Not all of the price increase is profit, however, since mortgage interest, taxes and other expenses can amount to 10 to 15 percent per year. Capital gains treatment provides a substantial part of the investment incentive, particularly during high interest rate periods, when the gain before taxes may not be too great.

There are several effects of a multiplicity of such land investments in a metroplitan area. Since only a fraction of the land held by investors in a metroplitan area can be absorbed for development in a given year, the investors who continue to hold become more inclined to hold out for a higher price to recoup their annual carrying expenses and realize a substantial gain. Land values continue to rise.

But more often than not the problems arising from land transference are of another sort. The conversion from farm to suburb is usually profitable for the prior owner, with the detrimental effects befalling the metropolitan community as a whole.

These detrimental effects result from speculation on land at the outskirts of the city, speculation that keeps the land out of use, or underused, disrupting the regular growth of the metropolitan area. Though land in or near an urban area is taxed much higher than rural land, the tax on an unimproved parcel is still low enough to be easily offset by the rise in its market value as the metropolis reaches to it, around it, and even past it. The growth patterns of nearly all our bigger cities show the scars of speculation—expansion is irregular and disordered, with subdivisions, shopping centers, and factories springing up far from the perimeter of the urbanized area, while large patches of land right at the perimeter remain empty. (See fig. A.) Upon investigation one will find that these patches often are being held by speculators, awaiting a higher price, a better deal. Comparatively low property taxes, together with the capital gains tax, encourage these speculators to hold the closer in, more desirable land and to refrain from improving it. Developers are forced further out into the countryside to find land for sale at prices that makes development economically feasible for low-rise housing and other low-density uses.

The pattern of low land taxation and relatively heavy effective taxation of improvements has a somewhat different effect on the spatial use of land in the outer developing areas of a metropolis. There, the tendency is to build more horizontally and less vertically in order to gain more space. Economies of scale in producing more space, which is added to the expensive mechanical core of a building, are gained through use of relatively low cost added land which also makes for minimum added taxable valuation.[19] Results include more generous use of land for individual buildings, a greater tendency to metropolitan spread and suburban sprawl, and more rapid consumption of fringe area land that has become available through the extension of roads and water and sewer mains.

The property tax not only discourages construction on unused urban land, but also discourages the rehabilitation of already existing structures. The slums in our cities are a major national problem. But the property tax system in nearly every city inhibits rehabilitation. Higher assessment (or even just the owner's fear of higher assessment) is a discouraging factor. If the owner is the resident, he is often an older person or a not very prosperous workingman, who can hardly bear the cost of rehabilitation, much less the higher taxes on a higher assessment. If the owner is a landlord, his tenants are likely to be low-income families who cannot afford the higher rents he might charge to recoup his costs of rehabilitation plus higher taxes. Except for those rare occasions when a poor neighborhood begins to attract the affluent (i.e., Georgetown or Capitol Hill in Washington, D.C.), the landlord has little chance of attracting persons who can pay higher rents.

Where the burden of local property taxes plus rising maintenance and operating costs becomes too great for the rental revenue that can be collected in a deteriorated neighborhood market, abandonment of the building by the owner frequently occurs. This has become a widespread and serious phenomenon, involving thousands of housing units in a number of large cities. The result is an exacerbation of the housing problem, as well as a loss of local tax revenues. [22]

C. EFFECTS OF PROPERTY TAXATION UPON LAND USE

1. Development of Land

As our cities have grown and expanded into the surrounding countryside, difficulties have arisen concerning the transference of land from agricultural to urban use. One of these difficulties involves assessment for tax purposes. Farmland generally is taxed at a relatively very low rate. But as the fringes of metropolis edge out closer and closer to a piece of property, its potential market value increases greatly.

This can lead to any of a number of problems. A farmer wishing to continue to plant his land and holding no other assets, could hardly afford the higher taxes based on the increased land value. A family may have owned a piece of property for many generations and may want to keep it but not build on it. Several States have adopted laws aimed at relieving the tax burden in such situations. These "differential assessment" laws will be discussed later.

The leapfrogging of development over and beyond pieces of land held unused or underused, requires that public improvements and services be extended to islands of settlement far from the city. This unnecessary increase in the distances to which services must be provided brings increased costs to both the individuals personally involved and to the metropolitan community as a whole.

There is usually an attempt by the local transit system to provide public transportation to new suburbs and factories. But the widespread settlements usually do not produce enough customers on a regular enough basis to cover costs, much less produce a profit for the transit company. The surburbanites depend on their private cars, and travel longer distances to work, to shop, or to seek entertainment; personal expenditures increase for gasoline and other automobile needs. Urban roadways are clogged with more and more cars and the community must spend to build new roads and to widen old ones.

The provision of water to scattered subdivisions has meant the elongation of distribution lines in some cases and the building of separate water systems in others. In either case per unit costs are increased. The expense of extending water lines is obvious. Less commonly understood are the additional costs involved in individual systems. The majority of the Nation's water systems serve quite small areas, operating on a scale far below an economic optimum. Therefore, except for areas in large population groups (e.g., over 1 million), the smaller the population served by a water system, the higher the rates charged the customers. The inefficiency of separate small water systems is but one of many economic costs of leapfrogging development.

Provision on a small scale of other utilities continues the pattern of higher costs for scattered development. Extension of gas mains and electric lines means greater capital outlay for the utility companies and higher rates for their customers. Treatment of sewage, like the provision of water, is most economical on a large-scale basis. The septic tank, a common feature of new, dispersed subdivisions, has not been satisfactory; many a suburbanite has known the pinch of paying for the extension of "city sewers" into his neighborhood. If the subdivision has it own sewage system, the community as a whole, through taxes or fees, must pay the high price of small scale operation.

3. Effects of the Property Tax on Building Improvements

The property tax as presently structured in most of the Nation taxes land and improvements at about the same rate, or in some cases, taxes improvements more heavily. Unimproved land on the outskirts of metropolitan areas has become an immensely profitable investment. Persons holding land on the outskirts of metropolitan areas are encouraged not to improve their land—though that well may be contrary to the interest of the community as a whole—for several reasons, including:

(1) Low property taxes—improvements would cause the parcel to bear a heavier property tax.

(2) Capital gains tax treatment—if land is not improved, a capital gains tax instead of regular income tax is charged, providing a 50-percent-or-better tax saving for the owner on sale profit.

(3) Increasing value of the land without effort or expense on the part of the owner—the expansion of the metropolis out to a parcel of land greatly increases the parcel's market value, without any investment by the land's owner.[17]

These are some of the main reasons—there are others—why land speculation is attractive and extensive enough to withhold from development substantial land on urban fringes. But it is detrimental to the ordered, economical growth of metropolitan communities. Some of these detrimental effects, those involving public improvements and services, have been discussed above.

But the holding of land in an unimproved status, so encouraged by tax benefits, has also contributed to a shortage of land for some building purposes. Because of advantageous tax treatment and substantial increases in market value, too much land is priced too high for purchase and development of anything other than the most profitable sorts of structures, often commercial, industrial, or luxury housing.

For the slum landlords, the present property tax system contributes to making slum housing a profitable investment. The deteriorated condition of the neighborhood often means that the entire real estate parcel, including the land, is assessed at a low value, even though it be near the center of town. The dilapidated state of the building provides the specific basis for assessment at a low value.

E. LAND-VALUE TAXATION

1. Potentials and Limitations

Presently, property taxes in the United States are levied against the value of the entire real estate parcel, land plus improvements; the land value is based on its present use and location. Appraisals of improvements for assessment purposes generally are largely dependent upon either replacement costs and depreciation or recent sales prices for a structure of similar function, such as a one-unit dwelling structure, having comparable amenities and location. In the case of rental-income properties the rent levels and occupancy experience are significant, permitting a valuation based on capitalized value. For land-value assessment, replacement cost cannot be used and values are established by comparison with recent sales, taking into account location, zoning, topography, and other factors of comparability.[27]

However, essentially it is the current market value for the parcel in present use that is assessed. The parcel might be wholly undeveloped, actively farmed, improved with a high-quality one-family home, or with a slum tenement. Present use, rather than the potential value of the land for development or redevelopment to a higher economic (greater actual or imputed revenue) use, generally provides the base for taxation.

Under this system of taxation every owner of property with possibilities of development or redevelopment to a higher economic use can become a speculative landholder without incurring unduly high carrying charges. If the land has an improvement, the only penalty may be a relatively low return on investment.

Low taxation of land in farm use or undeveloped land in the outskirts of metropolitan areas is conducive to landholding for a large increase in value. As far as urban development is concerned, the effect is the same, whether the property owner has been in possession for a few decades or has acquired the parcel recently for speculation. The land may be withheld from development or redevelopment, awaiting a price which cannot yet be paid in the market. Urban sprawl takes place as residential and other developers seek building sites at more reasonable prices over a much greater radius outward from the central city.

Within the central city, owners of improved property will be inhibited from making major improvements which would increase assessments and taxes. At the same time, in many central city locations, rundown properties can be carried at low taxes by owners awaiting market conditions that would support the sale of the property for a new high-value building site. Redevelopment to bring about such conditions is also retarded because prospective new building owners would be burdened with higher taxes—based on the building value—and rental market conditions might preclude high enough rents (or equivalent owner-occupant values) to cover the required tax payments.

Land-value taxation, also called site-value taxation, has been proposed to overcome the above-mentioned difficulties, and to stimulate less costly, more rational land-use development patterns. The idea would be to shift the burden of taxation to the land, valued in terms of its potential higher use if it were to be developed or redeveloped for such higher use. The much higher rate of tax payments, and probable annual increases as land values rise,[28] would encourage landholders in urbanizing areas to sell their land for development, instead of holding out for years for higher prices. The same would be true for owners of improved in-city sites which could be redeveloped to a higher use. Complementary to higher valuation and taxes on land would be lower taxation on building improvements. This would help stimulate building development and redevelopment.

Holders of land sites in and immediately around the center city would be induced to develop their land or sell to those who will, so there would be less leapfrogging out beyond the fringes of the metropolitan area. Reduced fringe development would mean a decrease in the expense of providing public services and an increase in the conservation of green areas and open space surrounding the city.

A rationale for land-value taxation was developed long ago by Henry George. His recommended single tax system was the extreme of land-value taxation. All increments of land value would be taxed at a 100-percent rate. The rationale was that land values rise as population growth takes place. Currently, there is also recognition that public improvements (roads, sewers, etc.) associated with population growth are more immediate influences in increasing values.

In line with this the suggestion has been made that a portion of the property tax be based on the costs of supplying water, street, sewerage, fire, and other services to a site rather than on the value of the site alone.[29] At any rate, according to the Henry George theory, since the landowner does nothing to increase values, the gains should be taxed away for the benefit of the population whose growth caused the increase in values.

If implemented today, it is doubtful that land-value taxation would take the extreme form advocated by Henry George. But by increasing the taxload on land and decreasing the load on improvements, it would still be possible to recoup for the public treasury more of those values created by the public, and leave with the individuals involved more of the values they have created in their improvements.

One of the concerns about land-value taxation is that it might stimulate overdevelopment and bring increased congestion to the cities. It should be noted that residential congestion is at its worst in the slums where ad valorem taxation of buildings has discouraged rehabilitation. Present low taxation of land huddles masses of people into limited areas while nearby acres stand empty. In the metropolis as a whole, land-value taxation should tend to increase the amount of land available at prices that make building economically feasible. In the center city, proper planning could assure the maintenance of parks and other open spaces.

One of the questions about the land-value taxation, today, is whether it could provide adequate revenues to local governments, so that property taxes levied against improvements might be greatly reduced. Answers to this question would vary greatly among localities, given present government jurisdictional boundaries. A highly developed jurisdiction, with high intensity use, high value improvements on land and little farm or vacant land, might not find it possible to reduce taxation of improvements to very low levels without an unbearable loss of revenues. On the other hand, jurisdictions with much undeveloped, potentially valuable urban land might be able to practically eliminate taxation of improvements and still have a net gain in revenues. This problem might be handled by appropriate balances between reduction of taxes on property improvements and increases of taxation on land within existing jurisdictions.[30] Another, more difficult possibility would be to reorganize local government jurisdictions, probably by enlargement through mergers, to provide a better balance of vacant and improved sites within a jurisdiction.[31]

A case can be made that in the national aggregate property tax revenues would rise as a result of a shift to land-value taxation. Support for this position includes evidence which argues that "Land values today equal or exceed building values in the United States." That statement is based, in turn, on evidence which suggests underassessment of land values. Prompt taxation of the increments in the land value would also enhance tax revenues. Untaxing the buildings (or at least greatly reducing the tax on buildings) would encourage more rapid development and increase demands for and values of land, broadening the tax base of urban area local government jurisdictions.[32]

Separate appraisal of value of land would pose a considerable technical problem, in view of locational differences and relatively infrequent vacant land sales in built-up areas to provide comparable values.

Other questions raised about land-value taxation concern the matter of who might benefit and who might lose from a shift to land-value taxation. There are two schools of thought with regard to effects on landlords and tenants, related to a lack of agreement as to whether present taxes are shifted to tenants or absorbed by landlords. One authority has said that "The tax amounts to a very high consumption tax on housing expenditures and thus tends to reduce consumer demand for housing." [33] A second takes the view that " * * * the tax on improvements is borne by the landowners except for minor effects of the tax on the intensive development of parcel." [34] The first view would seem to be more realistic, since unless rental revenues covered all of the landlord's anticipated expenses, including property taxes, plus a competitive return on his investment, he would not be in the property-owning business.

It would seem, therefore, that a reduction of taxes on improvements, which is presently shifted to tenants, would benefit them. The degree to which reduced taxation was passed on to tenants would depend on the extent to which the rental market was competitive. But why wouldn't the higher land-value tax also be shifted on to tenants?

The land tax is not shifted because the total revenue which can be obtained from a given parcel of land is determined by the supply of land suitable for given uses. A greater revenue cannot be extracted and an attempt to do so by shifting an increased tax to the user (i.e., to the tenant) would soon cause the disuse for that purpose. (This sort of effect is being dramatically illustrated in New York and other large cities where rising property taxes and other costs which cannot be shifted to tenants with a limited rent paying capability are leading to the abandonment of properties by owners.)

Present uses of land could be continued, however, because presumably with the changed composition of the tax base, the total tax on parcels with improvements would be lower, while the tax on a great deal of agricultural or undeveloped land would be higher, to produce the same aggregate amount of governmental revenue. Therefore, a net reduction of taxes on improved parcels could be passed on to tenants.

The land-value tax, it can be argued, would be more progressive than the present form of property tax. It would not be shifted to tenants who are generally in lower income brackets. Also, land holdings tend to rise with income. The low-income households generally own little or no land.[35]

If there were a changeover to a land-value tax system, that process in itself would change the current value of land and raise a serious question of equity for present landowners. Total rental revenue that can be derived from use of the land, at its highest and best use, will depend upon the market demand and supply for the good or service being produced, whether it be wheat grown on the land or luxury apartment housing. That total rental revenue (or equivalent thereof for an owner-occupant) which is fixed by product or service market influences, must be sufficient to provide for taxes, all other expenses and a competitive rate of return on the investment of the landowner. If the taxes are increased and absorb a greater proportion of total rental revenue, a smaller amount is left as a return on investment. In order to obtain the same competitive rate of return on the investment, therefore, the invested amount has to be smaller. In effect, the investor buying the land after land-value taxation had been instituted would have to pay a lower price than the value of the land before the change in taxation, in order to get the prevailing competitive rate of return. (See table 10.)

The recognition of the increased land-value tax burden would amount to a partial taxing away of incremental value. It would be borne by those who owned land when the land-value tax system was instituted. Some owners who had hoped to recoup all of their cumulative tax and mortgage interest payments, as well as make a capital gain upon eventual sale of the land, would find themselves facing an unavoidable net loss. This problem of equity for present owners might be ameliorated and the objective of accelerating land sales for development might be furthered by introducing the land-value tax on a graduated basis over a number of years. By shifting the tax burden from improvements to land in steps over a 10-year period the decline of present land value would be somewhat more gradual. Owners who faced a cumulative mounting loss as taxes on land increased might be stimulated to sell as soon as possible. This process would accelerate an increase in supply of land for urban development and redevelopment at prices which make rational development patterns more economically feasible.

In practical terms, some caveats regarding land-value taxation have to be observed. Acceleration of development of vacant and agricultural land use would probably take place, as suggested by experience with land-value taxation described below. There might be a danger of too rapid a withdrawal of certain types of agricultural land, although this danger is minimal in the United States as far as domestic self-sufficiency in agricultural products is concerned. Compensatory income payments might be appropriate for marginal farm operators who would be forced out of that occupation at an accelerated rate.

A more significant consideration is the potential effect upon the supply of low- and moderate-income unsubsidized housing in central cities and other intensely developed areas. The effect of land-value taxation would be to stimulate sale of real estate parcels containing older low-value housing for redevelopment for higher economic uses, such as high-rise luxury apartments and office buildings. In the long run this would be desirable to eliminate slum housing. Until there is an adequate supply of housing for low- and moderate-income families, however, the effect would be to exacerbate the shortage of housing for such families. A similar effect might be experienced by small businesses that are not in a position to start paying higher rents on short notice. This suggests two modifications that might be considered with regard to the possible institution of a land-value property tax system. First, as mentioned in connection with the equity problem, a graduated shift to land-value taxation over a fairly long time period might be helpful. Second, the time period might be considerably longer and the shift to land-value taxation much more gradual for real estate parcels which already have building improvements and might be sold for redevelopment.

In all of the foregoing considerations, the problems inherent in a transition to land-value taxation would have to be weighed against the long run benefits that might be realized. Limited American and foreign experience provides a basis for limited evaluation of the land-value taxation proposal.

2. American Experience With Land-Value Taxation

American experience with the idea of land-value taxation ranges from colonies founded expressly as single-tax enclaves, to a few cities taxing land at a higher rate than improvements. The single-tax colonies were founded around the turn of the century or soon after, and all by persons inspired by the writings of Henry George.