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Source: *The American Journal of Economics and Sociology*, Jul., 1967, Vol. 26, No. 3 (Jul., 1967), pp. 251-260

Published by: American Journal of Economics and Sociology, Inc.

Stable URL: <https://www.jstor.org/stable/3485518>

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The Real Estate Tax

By PHILIP H. CORNICK

IN 1664 THE DUKE of York sailed into the port of New York and demanded that the Governor of New Amsterdam surrender his city, and the Dutch colony of which it was a part, to the British Crown. The newly named City of New York was destined to become the largest metropolis on the continent. Since shortly afterward the city has derived a large part of its local revenue for city, county, and school purposes from a tax on the capital value of real estate. The former Dutch colony—now the State of New York—has also derived much of its revenue from a tax on real estate which its local units extended on their own rolls and collected for the state.

After the Revolution the new-born federal government was swamped with debts incurred from winning the war. It was deriving only limited revenues from excise taxes on alcoholic beverages and tobacco products, from tariffs on imports, and from sales of public lands. Its only other legal recourse under the constitution of that early day was to levy occasional taxes on the states in proportion to their populations. Since most of the states relied chiefly on the property tax, this tax on real estate thus also contributed a part of the federal revenues at times.

Eventually, however, the federal government began to find that its cash proceeds from sales of public lands were outrunning its expenditures. The cumulative surplus, mounting to what seemed to President Jackson alarming proportions, was then distributed to the states. New York State used its share for a state mortgage fund loaned to build, among other structures, what are now known as the "old law tenements." Building the Erie Canal attracted many immigrants. The demand for housing in New York City was great following the completion of the canal in 1825.

Some of these tenements still stand in the Lower East Side, in East Harlem, and elsewhere. They are variously known today as "railroad flats," "dumbbell flats," and "cold-water flats." Poor as they are by modern standards of ventilation, sanitation, and amenities, they were adequate in comparison with the housing the immigrants had left behind in Europe.

Even when the rate of immigration reached a million or more a year, enough housing was always available in the United States for the newcomers.

Until the distorted effects on the economy which followed the outbreak of the First World War, no government subsidies had ever been needed to

provide the housing required in New York City for newcomers, rich or poor.

County poorhouses, it is true, for young or old individuals, or families without a breadwinner; public hospitals for the mentally or physically incapacitated; and prisons for miscreants or felons were built and maintained with public funds. But federal or state subsidies, except for plants for war industries, or residences in neighborhoods near such industries, did not become necessary until fairly recently.

A number of critics point to the real estate tax as one important reason why state and federal aid is now necessary. This is a generalization which ignores the fact that the real estate tax is composed of two separate and distinct taxes—the tax on houses and the tax on land—which are quite dissimilar in their economic effects.¹

Depreciation on Century-Old Buildings

IT ALSO IGNORES the anomalous effects of some of the provisions of state and federal income tax laws on the distribution between land value and building value of the total assessed value of the worst slum buildings, some of them now well over a century old.

At present a building is an asset on which depreciation can be charged as an annual deduction from real estate income until the cost of reproduction new has been written off. Some of the oldest slums in New York City had stood for a third of a century before the nation first experimented with the income tax. This was done to meet the costs of the Civil War but was continued only for a brief period.

Near the turn of the century the state legislature outlawed the type of design and construction used in those early slums. None of that type has been built since. But purchasers of these outlawed buildings have somehow won the right to reduce their taxable incomes both for state and federal purposes. They are allowed to charge off depreciation on some buildings now over a century old.

When a man buys a piece of real estate of any kind, he rarely spends much time worrying how much he paid for the land and how much for the building, unless he has a taxable net income. Then he wants to make his net income as low as possible. Since he can charge off depreciation on buildings but not on land, it is to his interest to make his payment for the building appear as high as possible and that for the land as low as possible.

¹ See Dr. E. R. A. Seligman's chapter on the real estate tax in his book, *The Shifting and Incidence of Taxation*, 4th Ed. Revised, New York, Columbia University Press, 1921.

The pressure to do this is not confined to one slumlord, but exists for all who buy that kind of property.

When a building on a lot 25×100 feet or less falls down, burns down, or is torn down to save taxes, the resulting empty lot is quite unsalable since the building code now requires a larger parcel than that for a site. And no one has designed a successful method of using it as a parking lot. So it accumulates delinquent taxes for four years, after which the tax lien can be foreclosed under the *in rem* procedure, and the lot sold for a song. Under such circumstances, the current concept of what an obsolete slum building is worth goes up and of what land is worth goes down.

It will take much study to rectify all aspects of this anomalous situation. But one phase certainly is the abolition of the right of the owners of obsolete real estate to take credit for depreciation except on their actual expenditure for renovation of an approved type.

Changes in Concepts of Land Value by Assessing Office

LAWSON PURDY, in 1906, was appointed chairman and active administrative head of the Department of Taxes and Assessments in New York City. For several years he had been a close friend and admirer of Henry George. He had also read and had been impressed by what little had been written about the work of William A. Somers, another follower of Henry George. Ten years earlier Somers had devised and installed in St. Paul, Minnesota, the nation's first comprehensive system of valuing separately all types of property (land, buildings, and personalty) taxable under the general property tax laws which were in force at the time in that city (as well as in the United States in general).

Purdy had also been influenced by the work of Richard M. Hurd, chief of the appraisal office of a large mortgage bank in New York. In 1903, after a fruitless search for guidance in English and American economic literature, Hurd had written and published his pioneering *Principles of City Land Values*.

Purdy brought Somers to New York to advise him and adapted some of his ideas. Stated simply, he accepted the Somers theory that the source of urban land value was accessibility, which extended to private land holdings abutting on streets, the public or private improvements in, on, over, or under them, including sidewalks, paving, the sanitary and storm sewers, the water and gas mains, the conduits for telephone and power lines, and the rail lines for transporting passengers.

Not all land parcels in a block were strictly comparable in frontage,

depth, shape, size, topography, or location with reference to cross streets and alleys. Therefore a land value unit was devised, at right angles to the street, with a frontage of one foot and a depth of 100 feet, consisting of a hypothetical strip of land at or near the middle of each block front. For every block front the value of this unit foot was computed (using rules devised for the purpose) from a sale price or other available index of land value. Next, using a technique comparable to that applied by topographic engineers to interpolate on a topographic map elevations intervening between points of known elevation, a reasonable basis was devised for assigning a land value to each parcel of land on every block front in the city.

The 1909 Land Value Map

APPLYING THESE METHODS, Mr. Purdy published in 1909 his first land value map covering the entire city. He found one land value unit per block front in Manhattan Island sufficient for his purposes in most cases. There were exceptions, as in unusually long block fronts running between high-valued and comparatively low-valued streets—like, say, Fifth Avenue to Sixth in the Forties. In these exceptional areas he might present two or more.

The land value maps were revised annually. They were discontinued during the Second World War, ostensibly to save paper. Actually, the published data were no longer computed on the basis of actual indices of land values and the departments no longer used the maps for computing the land values entered on the tax rolls.

A cursory examination of the rolls, long after Mr. Purdy had failed to be reappointed, revealed that adjoining interior lots, identical in shape and size, were no longer identical in land value. The chief assessor's efforts to explain why made it apparent that *real estate* net income was the dominant factor in the current method of establishing land value. The value of the real estate, established by capitalizing the net income, minus the estimated cost of reproducing the existing building, left a residual which was assumed to represent the value of the land without improvements on it. This was supposedly the real estate appraiser's method of arriving at land value. It ignored the principles advanced by Hurd in his volume of 1903 and incorporated by Purdy in his system in 1906.

Hurd also treated land value as a residual but subtracted the cost of construction, not of the building actually on the site, but that of a building designed to accommodate the highest and best use of which the site was capable. Hurd's objective as chief appraiser for mortgage loans was to establish a land value base which would guide both owner and lender in

selecting a building capable of producing the maximum possible rate of return on the combined investment in land and building. In his book Mr. Hurd had used selected photographs of existing buildings, coupled with operating statements, to illustrate what happened when that objective was not achieved. The building might be too small to produce the net income of which the site was capable; or it might be so large, so ineptly located, or so wastefully designed that its cost of operation consumed all its gross income, leaving nothing for the land.

Neither Mr. Hurd nor Mr. Purdy contended that the method was either easy to use or infallible. Each realized it required a great deal of basic information, and great skill and experience in applying it.

Converting the Property Tax Without Disruption

HOW RAPIDLY can a property tax on real estate be converted to a tax on the capital value of land only without endangering economic stability?

Half a century ago the so-called Pittsburgh "graded tax plan" was authorized in Pennsylvania. Ever since then, many among both the advocates and the opponents of the land value tax have believed that the effects of a shift to a land value tax can be so disruptive to economic stability as to require caution and a gradual approach in the arrangements to effect the change. Never fully convinced of the truth of this widely held assumption, I was nevertheless so impressed by the large majority of able men who supported it that I was never able to think clearly in my efforts to combat it.

Recently I learned that a long-time friend of mine, an economist whose work in a narrow field of land economics had greatly impressed me, one who had incorporated the Hurd concept of "highest and best use of land" as a basic element in a volume he had written about the appraisal of real estate, was teaching his classes along the following line. Once a parcel of land has been improved by a building the two become so closely wedded that the resulting stream of real estate income can no longer be divided into land income and building income until a catastrophe, or a wrecker's ball, brings the wedding to an end.

After his long career as consultant to the American Bankers Association, I could see why he had come to believe that only the income stream as a whole was important to the bank or insurance company which held the mortgage. On the other hand, I could not accept his dictum that it was impossible to estimate separately the streams from land and from improvements which made up the composite stream from real estate. To do so would be equivalent to saying that Mr. Hurd and Mr. Purdy had both been wrong in trying to ascertain in advance on what urban site a Flatiron Build-

ing, for example, or a Radio City, or an Empire State Building, would be a safe investment.

From that point I went on to another conclusion. Urban land alone produces no income. It is only when it has a suitable improvement on it that it becomes capable of producing an income. When the owner of a vacant urban site pays taxes on it, he does so from income drawn from some other source.

That being the case, all taxes levied against urban real estate are paid out of real estate income, plus income from any other source received by the owner of unimproved or underimproved land. The real estate tax may be extended at a uniform rate on the composite value of land and building together. Or it may be levied by the Pittsburgh plan, with the tax on the assessed value of buildings set at a rate half as high as the rate on assessed value of land. Or the entire amount required by the city may be levied at a rate computed by dividing total assessed value of land alone by the sum needed by the municipality. Under each of the three methods the yields from the tax payable by aggregate taxable real estate can be made identical.

Several years ago, when, experimentally, I made the necessary computations for the City of New York, the current tax rate on real estate was slightly above \$4.00 per \$100 of assessed value. The rate would have been roughly \$12.00 per \$100 if the tax had been spread in proportion to the assessed value of land alone.

The Purchase of the Empire State Building

SOME TIME EARLIER a young investor from Chicago had arranged to buy the Empire State Building, which was reported to have cost \$51 million in 1929 for assembling and clearing the site and erecting the building. More than half of this sum had been provided by the Metropolitan Life Insurance Company.

The stock market crash in the fall of 1929 took place before the building's promoter, John J. Raskob, of Wilmington, Delaware, succeeded in getting contracts signed for the upper floors. "Blue chip" corporations were already tenants on the lower floors. But much of the tower extending to the eighty-sixth floor remained not only untenanted but also unfinished inside, resulting in the building's nickname at that time—the *Empty State Building*. This resulted in an annual deficit for taxes and other operating costs, part of which had to be recouped by borrowings.

Before the conclusion of the Second World War, Washington had become so overcrowded with war agencies that the government had to move

some of its permanent peacetime agencies. The Empire State Building was one of the available outlets, and a very welcome one. Thus the building at once became a solvent venture, able to pay all costs of operation including property tax.

The younger promoter, in order to get enough cash to swing the deal, had to find a substantial amount of additional cash over and above the Metropolitan advance. He did this by persuading the Prudential Insurance Company of American to buy outright the land on which the building stands for \$17 million and then to take in addition a 50 per cent first mortgage on the building. This brought that company's total investment to \$34 million. The balance of the first mortgage went to Metropolitan, of course. The mortgage and lease contract made the purchaser of the building responsible for paying, on receipt of bills from the city, the full taxes on both land and building, as well as the rental for the land.

For the year in which I made my computation, New York City would have needed a rate on land value alone of \$12.00 per \$100 to produce as much revenue as it expected to derive that year from a levy of \$4.00 per \$100 on total assessed valuation of real estate (land and buildings together). At that time the city had not yet entered on its rolls the prices at which the land and the Empire State structure had actually sold separately in the dual transaction reported by *Life* magazine. Both land and building were assessed somewhat lower than the price reported, and the ratio between the two was not quite the same. Approximately, however, the ratio of total land value on the rolls to total real estate value was the same as that revealed by the sales prices in the *Life* article.

My computations had been made for use in a speech at an annual dinner of the Henry George School. The response I got from those good enough to speak to me about my findings afterward was something like this: "Your computations must contain a big error. A tax rate of twelve dollars on one hundred dollars of land value would more than wipe out all the land value in New York City."

If that general impression among my audience was sound, then the opponents of the land value tax had been right all along. Or else I had overlooked certain basic elements in stating my case.

What I Had Overlooked

IT TOOK ME a long time to see what I had overlooked. Even now I find it difficult to state it in such a way as to convince my readers. My economist friend had spent much of his life pondering the value of, and the income

from, real estate. His concern had been the real estate on which banks and insurance companies could safely lend on mortgage other people's money which had been entrusted to them as fiduciaries. He had been right in his relevant conclusions, but wrong in selecting the words in which he endeavored forcibly and clearly to state those conclusions.

Some of my friends among the land value taxers are convinced that the term "real estate" is a misleading one because it combines two of what they consider economically incompatible concepts. I believe that they are also wrong. Only that piece of urban land which has a suitable improvement on it can have an actual present income. A vacant lot, it is true, may have a discounted present value of anticipated future income sufficient to justify an improvement loan. But only an incautious lender will advance such a loan without stipulating prompt action.

It was only little by little that it dawned on me how many facets of old controversies were illuminated by truths disclosed by my accidental choice of the Empire State Building for special analysis. In the first place, the rate of \$12.00 per \$100 of assessed value of land does not disclose the whole picture regarding the effect of that rate on the land value of the site on which the Empire State Building stands. At the same time that it increases the tax on the land itself, it wipes out entirely the former tax on the building. For the year in question, to compensate for wiping out all taxes on all buildings in the city, the rate on bare land alone would have had to be multiplied by three. But at the same time the entire property tax on the Empire State Building itself, exclusive of its site, is wiped out. For the increase in taxes on the site alone, which amounts to \$1,360,000, there is a corresponding offset of an equivalent amount for elimination of building taxes.

Let me point out here that this case in which increase in land tax is exactly equivalent to decrease in building tax is not by any means typical. Because of the manner in which tax rates are computed, this accidental equivalence for any particular building can occur only when a piece of real estate happens to have the same ratio of land value to its total value as the assessed land value in the entire city has to the assessed value of all real estate in the city. There are perhaps a number of one-family homes, chiefly in the boroughs of Queens and Richmond, which have approximate ratios of, for example, \$1,700 in land assessment to \$3,400 in building assessment. If so, they also would experience a sizable increase in the tax on their land value, minus an equivalent offset by the complete elimination of property taxes on the building. That is to say, the former tax on the total assessed value of "real estate" would equal the newly imposed tax on land value

alone on all properties for which one-third of the total assessed value was for land.

Savings More Than Offset Tax Increases

RESIDENTIAL PROPERTIES, whether one-family or multi-family—whether modest private homes or very “plush” apartment houses—are usually erected on land parcels worth less than half the cost of erecting the buildings. On such properties the savings on building taxes eliminated would come to much more than the increase in land taxes resulting from the change in method of taxation. The same statement probably applies also to many types of factory buildings, warehouses, wholesale houses, etc.

On all types of structures and uses for which prime location is essential—department stores, banks, office buildings—it may be that land values of sites may exceed the cost of erecting the structures. When that happens, the total tax on land may exceed the present tax on “real estate”—the land plus the building on it.

But in view of the substantial value of the building on properties of this type, there is still a large offset in building tax wiped out completely which helps ameliorate the effect of the high tax rate on land. In fact, if the land is so located that the owner feels confident that the land value will continue to increase sufficiently to warrant erection before long of a still larger building, on which taxes would also be completely wiped out, he might even be able to convince himself that the new method of taxation does him a favor.

But sites that are covered by “taxpayers” stretch all the way from business centers to distant outskirts—that is to say, sites not used to full capacity—and so do vacant lots which are not used at all. Such sites and lots would have little or no benefit from a palliating elimination of taxes on existing buildings to offset the increase in land tax, three times higher than the old. It is only there that the new tax rate on land would tend to wipe out speculative land values. Wherever there is land value sufficient to warrant putting up a building to take advantage of a potential use, the fact that no taxes would be levied on the new structure would make it probable the new building would go up.

Ending the Subsidy to Slumlords

BUT IT IS IN AREAS where slums exist that the most striking results would be seen—in the Lower East Side, in East Harlem, and in other areas of the five boroughs which have long been notorious for their squalor. In such areas the assessed value of the lands is considerably higher than that of the

“old law” tenements standing on them. The first message the slumlords would get, if the “real estate” tax were made to rest on land values only, would be that “the joy ride is over.” The big jump in the tax rate on land would be offset only by the total disappearance of the tax on existing low-valued buildings.

Whenever the slumlords have toyed with the idea of building new and better housing on their lands, the first thing they have run into is that the tax on the new building will be several times as high as per dwelling unit as on the present run-down dwelling units. This is not the case with the “low-cost” tenements erected by advances from either the federal or the state government for the stimulation of residential building. Strange to say, these advances are available only through a locally created public agency. Along with the cash subsidy also goes a pledge of tax exemption for a term of years from the local unit of government in which the new project is located. Many builders who have taken advantage of the state or federal subsidies are well aware that exempting the building from the local property tax is in itself perhaps the most valuable subsidy.

When public officials or citizens have become convinced that the exemption of buildings is an important and worthwhile subsidy, they still have two further important lessons to learn. First, they cannot hope to wipe out slums simply by offering tax exemption on all new residential buildings. To do so would merely add to the unearned profits of landowners, unless they also see to it that taxes on lands are increased as in the city-wide example for New York used in this demonstration. Because a suitable site at a proper price is as important to slum clearance as the provision of a suitable building.

The elimination of taxes on buildings is important. But equally important, if not more so, is changing the present property tax to one on bare land. Only then will the obstacles be removed which now stand in the way of making the right piece of land available for the erection of a building when it is needed and on the spot where it is needed. That is the second important lesson for all of us to learn.

Yonkers, N. Y.