Property Taxation: What's Good and What's Bad

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Property Taxation: What's Good and What's Bad

How to use property taxes more rationally and effectively.

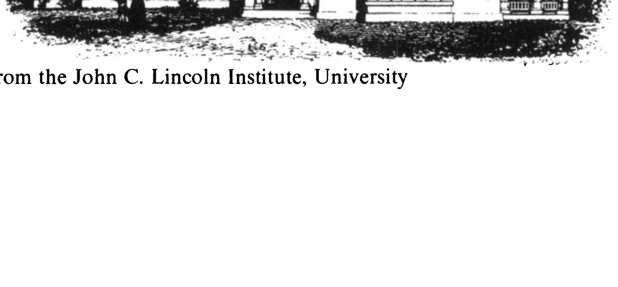
"It is the best of taxes. It is the worst of taxes."

The American property tax is really two taxes in one. The first, a tax on land values, deserves even more intensive use than it is getting. The second, a tax on man-made capital such as buildings, machinery and inventories, warrants even more condemnation than one hears.

Much of the "bad press" that property taxation is receiving comes simply from the amount of money involved. This year, property-owners will pay an estimated $44 billion to their local tax collector, compared with $27 billion as recently as 1967. The rising demand for services performed by local government has taxed them disproportionately, with particularly heavy burdens on those who own property in rapidly growing areas.

Concern about the cost and location of housing and the new sensitivity to the environment are forcing us to reexamine the role of the property tax. And while the U.S. Supreme Court recently refused to compel states to abandon existing uses of the property tax to finance education, the momentum from earlier decisions in the other direction assures a continuing pressure for change.

Any generalizations about the property tax are



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likely to mislead. One of its most striking characteristics is its variability. In 1970-71, the burden ranged from a high of $296 per capita in California to a low of $41 per capita in Alabama:

Annual Property Taxes—1970-71

	Per $1,000 of personal income	Per capita
U.S. average	$47	$184
California	67	296
Massachusetts	66	286
New Hampshire	64	222
Wisconsin	63	231
New Jersey	60	273
New York	55	259
Michigan	50	202
Illinois	45	200
Ohio	44	172
Pennsylvania	34	131
Georgia	33	107
Mississippi	30	77
Tennessee	28	85
North Carolina	27	85
West Virginia	25	74
Louisiana	24	72
Kentucky	23	70
Delaware	21	88
Alabama	14	41

And there is almost as much variance within states as among them, not only in the level of the tax but also in its structure and administration.

What's good about it

The variability of the property tax suggests one thing that is good about it. It is an instrument by which some truly local decisions can be made. By having a decentralized tax system, people in one locality are not thwarted, inexorably, by decisions taken elsewhere. Despite the emphasis in some circles on equality, many of us also want freedom and opportunity to act differently from others—and want not to be held down to a level set by others who may live in areas that are quite different. Who, for example, would want to limit his children to a level of education that might satisfy, say, a majority of the voters in a state? Property taxation stands out as a source of strength for local independence.

Similarly, the property tax gives the voter a more direct voice in determining the taxes he pays and the amount his local government spends. The income tax increases automatically as incomes rise. By contrast, the only automatic increases in property taxes come from new construction. An increase in assessed valuation or a boost in the tax rate both require a positive act—and both can spark voter resistance. The property tax perhaps affords voters the best opportunity to relate budget proposals involving higher spending to the question of whether higher taxes are desirable.

There is also an element of justice in the property tax system, in the sense of a *quid pro quo.* Generally, the localities in which the burdens on residents are highest are those providing the most service. (One exception is that some localities contain concentrations of industrial property that permit a substantial shifting of the tax burden to nonresidents.) Still, within communities, the relation of benefits to costs will be crude, or even perverse: families with relatively large property holdings will pay more than those who get equal services. And some critics believe that where the tax base per capita is low, there is inadequate—and inequitable—spending, particularly on education.

One factor that tends to be overlooked is the way distortions are smoothed out over time. Property taxes have worked their way through the economy: some elements have been capitalized or discounted as owners and users take the tax into account. The inequalities and crudities that might have been there in the beginning lose some of their sting. In other words, an old tax is a good tax.

In a meaningful sense, part of the tax is no current burden on the present owner. In most communities at least 15 to 20 percent of the property tax is a levy on land values at rates that have been in effect for many years, and it is therefore built into the price of the property. The homeowner is no worse off when he pays this tax than he would have been in its absence, for he would have had to pay a higher price for the property.

A terrible tax

Still, there are serious economic distortions that arise from property taxation. And they are more serious because, in many cases, they are unnecessary.

Most of the criticisms of property taxation depend upon the height of the effective tax rates. Any tax that brings in large revenues is bound to have substantial nonrevenue effects. Individuals and businesses alter the way they carry on their affairs in an attempt to reduce the tax burden.

Although property tax rates seem small when expressed as percentages, appearances are deceiving since they apply to *capital values.* A 3 percent property tax equals 33 percent of the pretax net income from a property that yields 6 percent to the owner. The tax frequently exceeds 25 percent when expressed on the same basis as a retail sales tax.

Taxation represents government's use of coercion. And what constitutes fairness in the use of that compulsion in part depends upon the reasons for the growth of government spending that requires increased taxes.

The property tax has been criticized as running counter to one concept of fairness by burdening low-income groups more heavily in relation to income than those with higher incomes. (Families with higher incomes usually do pay higher absolute amounts since they tend to own more property.) It is true that a regressive element does exist. But if as much as half of the tax on business, utilities and rental residential property is assumed to remain on the supplier of capital–i.e., only half is shifted to the consumer–then the picture is one of substantial inequality against the middle- and upper-income groups. Obviously, assumptions about shifting make a great deal of difference.

I estimate that less than one-tenth of the total property tax falls on families with less than $5,000 income, even where regressivity is most evident. For most families, the property tax is roughly proportional to income; the $20,000 family bears about twice the tax burden of the $10,000 family.

Much more valid criticisms can be levied against the property tax, however. There is frequently a perverse burden in relation to the cost of government. If taxed according to their full current worth, new well-constructed buildings are taxed more heavily than slums. This means that an increased property tax can represent a cost to the private owner for which there is no comparable increase in government services. Moreover, compared with the slum, the high-quality, high-tax building brings the general public some distinct "neighborhood benefits."

Obstacles to urban renewal

Heavy taxation of new buildings stands as a tragic example of mankind creating needless obstacles for himself. Cities that urgently need to replace obsolete buildings nevertheless put tax impediments in the way of progress. No one tried deliberately to base local finance on a tax that would favor holding onto decrepit structures while penalizing the new and the good. But the higher the rate of a community's property tax, the less desirable it is for investors to put funds into new buildings.

Likewise, the property tax discourages maintenance and modernization–partly because of what assessors actually do in counting improvements as an increase in the tax base and partly because of fear of the assessor. An owner acting in a logical way will not be deterred from maintaining his property by a property tax, assuming such an investment offers a better after-tax return. But he may fear that a "repair and maintenance" job that has visible results will more likely attract the attention of the assessor than other expenditures.

The law of the cube

The property tax on buildings tends to impose an "excess burden" on taxpayers–that is, the tax costs the property-owner more in terms of forgone benefits than the amount that is actually paid to the government. This is because of a hidden burden in the sacrifice of possible economies in construction. The expense per cubic foot of construction declines as the size of the house or office increases. Resource allocation in the economic sense is most efficient when labor and raw materials go into more commodious housing. But the property tax, by increasing the price of housing, creates a pressure for building smaller units, thus depriving the public, unknowingly, of an opportunity to exploit "the law of the cube."

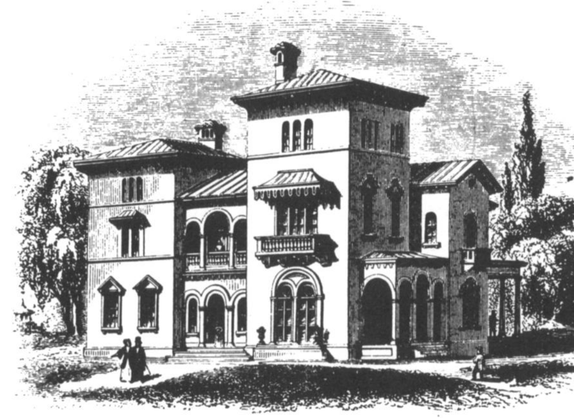
Problems also arise from the variation of tax rates. Rates much above average in one locality will reinforce incentive for creating "islands" of relatively low tax rates nearby. A few areas can get by with lower rates, attracting capital for new structures and becoming, in effect, low-tax enclaves. Lower tax rates on the fringes of an urban area encourage dispersal of some activities, including housing, that "ought" (in a full economic sense) to be closer to the center of things. The existing pattern of taxation arbitrarily favors *horizontal* over *vertical* growth in metropolitan areas. The resulting land use then imposes higher real costs—time and money spent in traveling to and from work, higher expenses for water supply, sewage and garbage disposal, and the reduction of some economic and social benefits that come from concentration of population.

As the property tax falls on business, it affects decisions about how, where, how much and in what forms to invest in productive facilities and to operate them. The influences that grow out of tax considerations will rarely help companies to produce more efficiently. For business, in general, taxes are costs without direct benefits. Most local services—education, welfare, sanitation, police and fire protection—are for the consumer rather than for business as such. Logically, each rise in property tax, unless matched by improvements in local service, will tend to reduce the use of structures, and the amount of production will suffer. The localities that impose high taxes will thus be less able to improve their economic base. While some companies are firmly attached to a specific location, firms that deal in highly competitive markets cannot afford to incur avoidable costs that do not result in a salable output or a reduction of other costs.

High property tax rates also stimulate the expansion of the scope of governmental (as opposed to private) activity. They give misleading signals, for example, on the relative desirability of "public housing" and municipal ownership of utilities. On a more subtle political level, high property taxes provide greater incentives for some groups to press for exemption and thus further distort the tax structure.

There must be a better way

Although any human institution has its defects, property taxation as it now exists has more defects than are inherently necessary. The property tax still suffers from needlessly poor administration. Assessment at levels far below market prices con-



tinues, despite the long-established conclusion that "underassessement" leads to "malassessment." Appeals procedures do not, as a rule, give the taxpayer effective opportunity for review and possible correction. Payment must still be made in large amounts rather than in convenient installments.

Fortunately, the administration of property taxation has been improving over the past several years. State governments are assuming a larger role in setting goals and standards, arranging assessing districts, training staff, supervising equalization, providing facilities for appeals, and fostering innovations. Such professionalism, in conjunction with a reduction in purely local influence in assessment, can help deal with the evils of favoritism and corruption.

But the way to eliminate the perverse effects of property taxation is through a basic change in the structure of the tax. Land should properly become the base for much more of the property tax, and less burden should be placed on buildings, machinery and inventories. The relation of tax rate on land to that on man-made capital could be on the order of as much as five to one. Greater use of special assessments also deserve consideration. A new form of tax on urban land might be appropriate—some objective elements such as plot size and location being used to determine the amount of the tax. One result would be to reduce the weight placed on value alone; another would be to relate the tax more to the cost of providing certain services such as streets, sewers and fire protection.

Such changes could well reduce the rapid increase in land prices, which has been a source of complaint by those concerned with the cost of new housing.

The nonrevenue results of such a restructuring would depend upon the new tax rates. Probably there would be little effect where the tax rates are low. But in other localities, including most big cities, the present tax rates are at a level where the change would significantly alter the arithmetic of real estate investment. The incentive system for land use would be modified, and a better pattern of resource allocation would result.

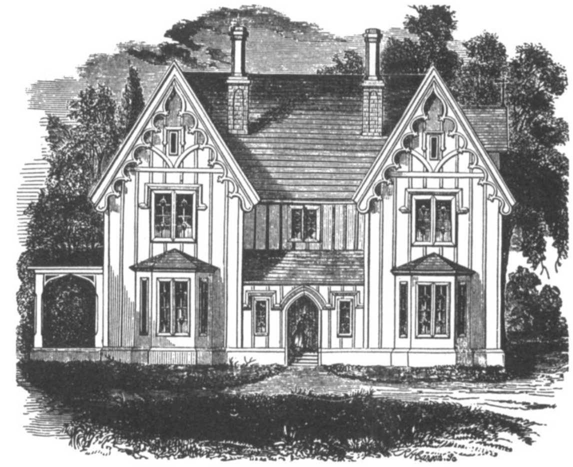
Land is the one exception to the rule that a high tax rate will reduce the quantity of whatever is subject to the tax. In its natural state, land does not come into existence because someone paid to get it produced. At best, the person who sells land will have invested money in making the parcel and the neighborhood more desirable. But most urban land brings prices which are vastly greater than the worth of such inputs.

Price has an economic function other than getting things produced: that of guiding use, preventing waste in consumption, and allocating resources according to their relative productivities and scarcities. Thus a "high" price for some land is essential for encouraging the best available use. But to assure efficient allocation, it is essential only that the user pay more, not that the owner receive more. In other words, the government could take more of the price of the land without affecting the supply. Indeed, the effective supply of land might well go up as owners sought more aggressively to get the best possible income from land that was costing more in cash to hold.

The concomitant reduction in the tax rate on buildings and machinery would reduce the ill effects discussed above. The tax element of cost would drop, the most notable reductions being made on newer and better buildings. Some of the perverse encouragement of slums would be exorcised. Lowering the tax on improvements would increase the attractiveness of such investment; and private enterprise—decentralized, but powerful—would operate to replace old buildings and machinery with new. Slums would not all be replaced by modern structures before the next election, but the process of replacement would certainly be accelerated.

An element of justice

Raising the tax on the basis of the existing value of land would generally work against the present owners. Some land, especially that which is largely vacant or underutilized, would receive large in-



creases in assessments, hitting at the legitimate expectations for which recent purchasers sacrificed other alternatives. Yet withholding of a resource—land—from optimum use scarcely justifies the reward of tax favoritism. In contrast, investment by owners or tenants in improving land deserves the same consideration as investment in structures.

Much of what people pay for the use of land (the original and indestructible qualities plus elements growing out of community investment) reflects a socially created demand for land. The community can legitimately recapture in taxes some of the values it has created—including values resulting from local government spending on streets, schools and other facilities.

Over the long run, landowners would get less of the increment in land values; the public treasury would get more. This would relate government financing more directly to benefits, at least in the geographic sense: localities doing most to make themselves attractive would have most of this revenue source. Eventually, the tax on land values above their present levels would be almost burdensomeless; and where land values dropped, the annual tax would decline.

Today, keeping urban and suburban land idle while waiting for the price to go up may cost the owner rather little, especially in out-of-pocket dollars. He pays no income tax on forgone income, and his ability to deduct property taxes in computing taxable income further reduces the net cost. In addition, the assessor often "cooperates" with the owner of underutilized land by coming up with lower figures (relative to full potential) than for developed property.

With reduction of the tax on buildings and machinery, conditions for putting land to better use would improve. Both the "negative" aspects of higher land taxes and the "positive" element of lower burdens on new buildings would aid replacement. Heavier taxation on land coupled with lower taxes on improvements would reduce "urban sprawl." New possibilities of, and incentives for, compactness would appear over an urban area. The new tax relations would weaken the power of some landowners to force people in a growing community to settle farther out. More intensive use of the central sections would result, and the filling-in of the idle land and upgrading of older areas would be accompanied by more vertical development of better-quality facilities. Horizontal expansion would be somewhat less attractive compared with more intensive use of land. Savings in transportation would result, both in terms of time spent in traveling and in the cost of vehicles and roadways required for shorter trips. Elevators would do more of our transport; autos, less. Savings on sewer, water, electric and other utilities would result.

In the short run

What might be done soon? Quite generally, land is underassessed relative to man-made capital. Sometimes assessments on vacant or near-vacant land seem designed to encourage speculative underuse and to stimulate price increases on land. 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. Raising assessments of land to put them on a basis comparable with other properties would correct some existing imbalances. Tax holidays for new buildings or machinery—or for substantial rebuilding—can provide some relative encouragement. So also can freezing the tax at the preexisting amount on the properties that are replaced. General exemption of increased values resulting from modernization can reduce a tax impediment.

Much remains to be done—and much can be done—to make property taxation a truly strong and constructive element of the American tax system. In some respects—such as supporting local independence and capturing some of the socially created land values for public use—property taxation ranks high among revenue sources. Our challenge is to press ahead with the improvements that are both necessary and possible.