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Site Value Taxation in a Declining City

By PAUL S. KOCHANOWSKI*

ABSTRACT. The relationship is analyzed between the *economic decline* of a *central city* and the likelihood that a *site value tax* will be politically acceptable. *Public choice* and *land use models* are combined to generate a scenario of land use changes and changes in improvements to land ratios which determine whether a specific *property owner* will gain or lose from a revenue-neutral site value tax. A case study is presented which substantiates many of the effects suggested by the model. In general, *private* and *public sector* responses to a city's decline result in an atmosphere that is relatively hostile to site value taxation.

I

Introduction and Study Purpose

IN A RECENT ARTICLE, Richard Netzer argues that in spite of the many advantages that a site-value-tax seems to offer, and in spite of the many economists who also advocate it, the likelihood of public acceptance is relatively remote (Netzer, 1984). The public, he suggests, sees the taxation of unrealized capital gains as 'unjust,' and since this is what a land tax does, they reject it. Only in passing does Netzer mention that numerous American cities are in economic difficulty and that this too may hinder future adoption of site value taxation. The purpose of this paper is to show that central city economic decline brought about by suburbanization may be much more damaging to the future of site value taxation than Netzer seems to imply, perhaps even more so than the unwillingness of Americans to allow unrealized as well as realized capital gains to be taxed. This results from the interaction of three forces: 1) economic decline itself; 2) adjustments in site usage due to decline; and 3) political responses to a declining central city business district.

The paper is divided into six sections. In section 2, political aspects of a revenue-neutral site value tax are discussed. In section 3, the winners and losers from a site value tax are evaluated for a city undergoing population losses from suburbanization. Section 4 analyzes local government responses to decline. Section 5 presents a case study emphasizing some of the results reached in

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sections 3 and 4. The final section of the paper describes the major results of the paper and the areas where additional research is necessary.

II

Political Models of Tax Choice

ASSUME THAT GIVEN THE CURRENT SYSTEM of property taxation, individual property owners are in equilibrium as to the optimal development of their sites. If part or all of the revenues currently raised is to be raised by a revenue-neutral site value tax, then within aggregate revenue neutrality, there will be gainers and losers in terms of estimated tax payments before and after the change.¹ Moreover, the current property tax system misallocates resources. Property improvements are inhibited,² sites are underdeveloped (Douglas, 1980; Rybeck, 1977), uneconomical land speculation occurs (Douglas, 1980), inefficient locational choices evolve (Rybeck, 1977), to name a few. Thus a shift to a site value tax has two effects—one a tax payment effect; the other a resource allocation effect.

Given these two effects, a property owner will favor the shift if he or she perceives that the *combination* of tax payment and resource reallocation changes lead to a gain in utility. In this setting, the shift in the tax base from improvements to land separates property owners into three distinct groups.

<u>Taxpayer Category</u>	<u>Tax Payment</u>	<u>Utility Change</u>
A. Favor Change	lower	increased
B. Favor Change	higher	increased
C. Oppose Change	higher	decreased

Those in group A either gain solely from the shift in bases, which lowers their tax bills, or may gain doubly from lower tax bills and the ability to make better decisions about their properties; for example, a residential owner who can now add an additional room or a pool to a home without tax consequences. Obviously those in this group favor a site tax. Property owners in Group B also favor a site tax in spite of higher tax payments. These are property owners for whom the property tax system has placed a large excess burden in terms of resource misallocations. Some of these are owners who see a site tax as increasing the rate of economic development which they view as positively related to their own profits; for example, a restaurant in a downtown area. Members of Group B thus gain enough from resource reallocation effects so that they still favor the tax change even when faced with higher tax bills. Finally, members of Group C gain little, if anything, from resource reallocations the site tax allows or from positive side effects of the shift, such as an economic development. Members

of Group C are owners who may have locked themselves into a site use that they perceive is fairly long term with no conversion likelihood in spite of the tax base shift. Members of Group C also may be property owners such as land speculators who gain from the current system or property owners who enjoy favored status in terms of exemptions the current system has granted them. Members of Group C understandably can be expected to oppose the change.

A tax choice simply based on constituency interests would entirely depend on the number of property owners in each of the above categories. In reality, however, there are political agents whose own views and interests in the tax shift may or may not coincide with those of the broader electorate. "Their self-interest may differ very substantially from the interest of constituents, and electoral control instruments may be too crude to bring the two sets of interests into correspondence. Within broad threshold constraints, those empowered to take political action may exercise discretionary authority, with respect to taxation or anything else." (Buchanan, 1987: p. 32)

The contention in this paper is that economic decline shifts the distribution of property owners from A and B toward C. In addition, economic decline may make political agents who are crucial to any such tax shift, less sympathetic to site value taxation.

III

Winners and Losers: A Simple Model

LET THE *i*TH PROPERTY OWNER'S tax payment under the current system and a site value tax be given as

$$P_c = \frac{R_0}{I + L} (I_i + L_i)$$

$$P_{sv} = \frac{R_0}{L} (L_i)$$

where P_c and P_{sv} are tax payments under the current system (*c*) and the site value tax (*sv*), R_0 is the amount of revenue to be raised by either tax, I and L are the locality's assessed value of improvements and land, respectively, and I_i and L_i are the *i*th property owner's assessed value of improvements and land, respectively.³ Then the *i*th property owner's tax bill increases (decreases) depending on whether P_c is less than (greater than) P_{sv} . This simply boils down to a comparison of two ratios, (I_i/L_i) and (I/L) . Three possibilities emerge.

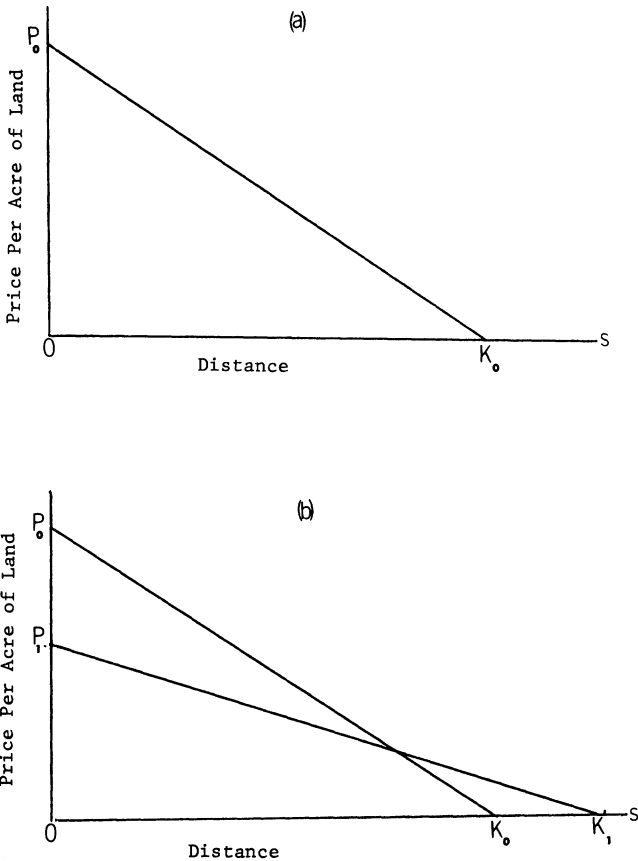
1. $(I_i/L_i) = (I/L)$ and $P_c = P_{sv}$ (same tax bill)
2. $(I_i/L_i) > (I/L)$ and $P_c > P_{sv}$ (lower tax bill)
3. $(I_i/L_i) < (I/L)$ and $P_c < P_{sv}$ (higher tax bill)

Hence, an individual property owner's tax bill change depends entirely on his or her improvement to land ratio when compared to that of all property owners in the taxing district.

How might the category of an individual property owner be influenced by economic decline?

Over time one would expect both the aggregate and individual ratios to reflect exogenous changes taking place in an urban area. Let us assume that at time 0 our city has the typical land price pattern given in Figure 1 panel a where P_0 is the price of land at the very center of the city with land prices declining with

Figure 1
LAND PRICE GRADIENTS BEFORE (a) AND AFTER A CHANGE IN
TRANSPORT TECHNOLOGY (b)



movement toward the periphery.⁴ Such a land price gradient represents a core dominated city where the center of the city is the dominant focus of economic activity. High land prices at the center capture the value of access. Land prices away from the core are lower because households and businesses face higher transportation cost. Until 1940 or perhaps even 1950 or 1960 many major cities could be approximated by the core dominated city model.

Let us now introduce into this model an improvement in transport technology that reduces time and/or money cost of transportation.⁵ Rent at the center is based on the savings in transportation costs and, other things equal, such as population and per capita income, will accordingly decline from P_0 to P_1 (Figure 1 panel b). Furthermore, since land prices throughout the city will fall, households will have an incentive to increase their consumption of land thereby expanding the boundary of the city from K_0 to K_1 . That is to say population spreads out and suburbanization ensues (Alonso, 1964: pp. 111–113). If the per unit price of land (per acre, or per square foot, etc.) is given at $t = 0$ as $P_L = P_0 - r_0S$ and $t = 1$ as $P_L = P_1 - r_1S$ where S equals distance from the core, then the change in the aggregate value of a city's land base because of the improved transport technology is approximately⁶

$$\Delta L = (\pi/3)[(P_1^3/r_1^2) - (P_0^3/r_0^2)].$$

Since $P_1 < P_0$ and $r_1 < r_0$, the sign of ΔL is unclear. According to Haig, "an improvement in transport, *ceteris paribus*, will mean a reduction in friction and the diminution of the aggregate sum of site rentals." (Haig, 1926: p. 422) Ratcliff also endorses this view (Ratcliff, 1947: p. 372). Nonetheless, ΔL ultimately depends on the price elasticity of demand for land space by residential users.

Yet, while it is quite possible that the aggregate I/L ratio will rise, it is also probable that many properties in the core of the city will find a reduction in their improvements to land ratios. Retailers and other businesses dependent on household spending will respond to the spreading out of the population by relocating to the suburbs. With population and income assumed constant, vacated core improvements will go wanting for new tenants. One need not visit many cities experiencing decline to see the validity of this statement.

Furthermore, there will be a tendency for the improvements to land ratio to drop in the core of the central city simply because of the relative change in the price of land to improvements. The bids offered for core land will be lower because of the reduced value of a central location for certain activities. But, in addition, those lower land values will lead businesses to develop less intensively any given site.⁷ Marginal and average cost per building floor rise beyond a certain structure height because the construction costs per floor begin to rise as the building grows taller. The rise in cost has two sources: First the need for heavier

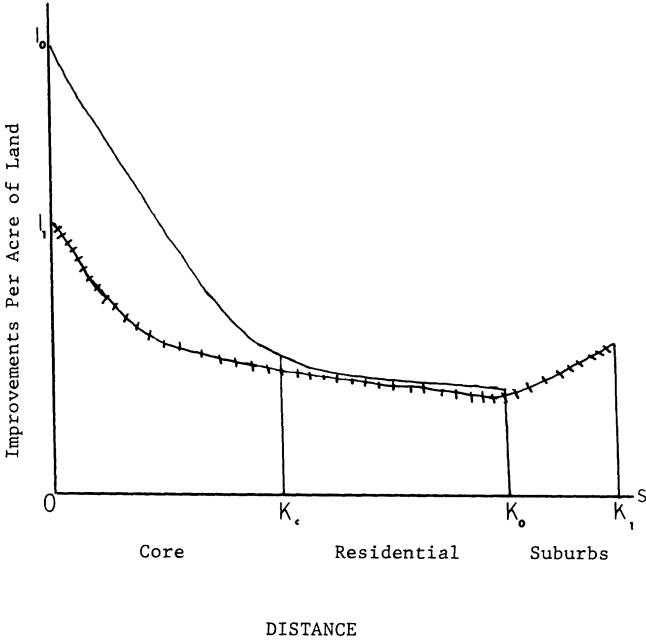
foundations and structural elements and, second, the shrinkage of usable space per story as height rises, on account of building setbacks and the need for additional space-using elevator shafts (Heilbrun, 1987: p. 115). An additional floor will be added “instead of spreading the building over more ground [when] a saving in the cost of land is affected which just compensates for the extra expense and inconveniences of the plan” (Marshall, 1916: p. 448). Lower land prices therefore mean fewer tall buildings and less intensively developed sites.

Most of the adjustment in individual properties to an exogenous change in transport technology will take place in the central city core. This results from several factors. First, the activities most sensitive to shifts in the distribution of households are located in the core. Density functions reported by Mills (Mills, 1972: p. 42) indicate that over time retail and service employment exhibit the largest central city density decline of any employment sector. Rough calculations show that in older SMSAs the elasticity between central city retail employment and population is around 2.0 (Heilbrun, 1987: p. 42). Second, the speed with which adjustments take place is relatively greater for retailing and services than other types of employment (Mills, 1972: p. 56). Such activities will, as a consequence, move from central city to suburban locations earlier than others. Third, the absolute and the percentage land price changes are largest in the core and the types of activities located in the core most likely to have the highest elasticities of substitution of between land and improvements.⁸ All of these lead one to believe that the quantity of improvements in the core will be drastically curtailed by the decline in central city population.

Figure 2 shows a likely pattern of improvement changes in response to a change in transportation technology. The solid line in that diagram represents the pre-suburbanization situation and the hatched line the post-suburbanization case. Large declines of improvements per acre take place between 0 and K_c , the boundary of the central business district. Between K_c and K_0 , the old boundary of the city, changes are relatively small. Properties in this range are mostly residential, less affected by suburbanization, less prone to adjust to any exogenous change, and less likely to make any improvement to land adjustments in response to a decline in land prices. Referring back to Figure 1, one also sees that land prices in this range do not change by very much. Beyond K_0 improvements per acre expand as activities move to suburban locations.

The improvements to land ratio for the entire metropolitan area may rise or remain relatively stable because declining ratios of improvements to land at the center are being offset by increasing ratios of improvements to land in the suburbs. Nonetheless, many property owners in the central city, especially the central city core, will find their ratios of improvements to land falling below the metropolitan average, thereby lessening the likelihood of their acceptance of site

Figure 2
IMPROVEMENTS PER ACRE BEFORE AND AFTER SUBURBANIZATION



value taxation. Indeed, as the suburbs develop more and more fully, increasing numbers of property owners in the central city will find $I_i/L_i < I/L$ and site value taxation generating higher tax payments. Thus, the likely effect of the exogenous improvement in transport technology will be to make site value taxation politically unacceptable to many property owners in the older declining central city. Furthermore, since a number of such taxpayers will be prominent business people in the core, who generally have an inordinate amount of political influence, public officials will also show little sympathy to site value taxation regardless of arguments made in its favor.

IV

Government Responses to Decline

THE VERY RESPONSES OF GOVERNMENT to decline may also make site value taxation a less attractive option. Local governments apparently see vacant stores and a

declining core as failures for which they will be held directly accountable. While one can point out to local officials that a reduction in the tax on improvements will spur investments in the core and point to studies documenting such effects (McGuire, 1985; Pollock and Shoup, 1977) few politicians are willing to stake their own survival on the whims of the market. They hence opt for more direct means of reviving the downtown area.

The most common means to development is through government purchases of properties under some form of urban renewal program. In the very largest cities (New York, Boston, Chicago, etc.), where office jobs are growing very rapidly, vacated sites, after being resold, are extensively developed and the value of improvements to land after renewal is greater than before. This is not the case, however, in smaller cities where office jobs are not growing rapidly.

Although not very much is written about such cities, it appears that vacated sites are very difficult to fill. Indeed, most attempts to revive downtown areas in such cities have failed. As a response, vacant sites are often taken over by governments and made into parks or used for other government activities. In other instances, large exemptions against assessed improvements are offered as a way of enticing investors to build downtown. For example, Alonso writes of the case of a central city in which renewal had resulted in \$180,000,000 of new construction and an increase of \$200,000 in yearly property taxes to the city . . . about one tenth of 1 percent of the total investment (Alonso, 1967: pp. 448–49). Local governments may also exempt existing improvements from taxes as a way of making them attractive to activities that otherwise would find the cost of a downtown location prohibitive.

The end results of these selective exemption policies are quite obvious. First, the ratio of improvements to land for properties receiving the exemptions drops thereby making such properties less likely to gain from a site value tax. Furthermore, even those properties that still gain from a site value tax will gain less than they would without the exemption. Second, some of the recipients of the largest exemptions are large property owners who are intimately involved in the local political process. These taxpayers have little to gain and perhaps much to lose from a restructuring of the tax system. Although they may not openly oppose site value taxation their support at best will be lukewarm.

V

A Case Study

A RECENT STUDY evaluating the use of site value taxation as a substitute for the current property tax system highlights many of the effects discussed above. The study was performed on a set of about 4,500 properties located in or near the

central business district (CBD) of South Bend, Indiana, a city of about 250,000 population located in northern Indiana. Over the past 25 years the city had suffered major economic setbacks, which left population relatively stagnant (Peck *et al.*, 1987).

During that period the central city continuously declined in importance as population migrated to suburban locations. At 1950, the central city represented 56 percent of the population. By 1980, its representation had fallen to 45 percent. Moreover, at 1960 there were 132,445 people in the central city and 238,614 in the entire metropolitan area. By 1980, central city population had declined to 109,727 while population in the metropolitan area had risen to 241,617.

The effect of the decline on the CBD was devastating. In the early 1950s, South Bend's CBD was a vibrant retail center with five major department stores, a host of men's and women's clothing stores, several five and ten stores, drug stores, jewelers, many restaurants, hotels, and office buildings. By 1987, virtually every retail establishment had gone out of business. Today what remains of a once vibrant retail center is a drug store, two or three small clothing stores, a bakery, a few specialty shops, and some fast food restaurants. Although several new office complexes have been built, these have mostly siphoned off renters from older office structures, which have since been demolished. Perhaps most telling of all is the fact that the piece of property in 1950 that had been the most intensively developed square block in the downtown area is today a combination parking lot and city bus terminal pick-up and distribution point.

The effects of the decline on the ratio of assessed improvements to land in this CBD are also quite telling. About 25 percent of the properties (1,078) have no improvements whatsoever. One-third of the properties have a ratio of assessed improvements to land of less than 1.0. The mean value of improvements for the entire set of properties is 4.8, which is far below the 8 to 1 ratio commonly given for single family residences.

Perhaps most surprising is the substitution effect of land for improvements that has taken place on many sites. Instead of high rise parking facilities, as one typically finds in large cities where land is expensive, many of the downtown sites have been converted into parking lots. New and used car dealers with large stocks of cars have also moved into the downtown area. Fast food restaurants with large parking lots exist. Even the new post office is much more land intensive than the old. The old post office was a multistory building that occupied one-fourth of a square city block. The new post office is a single story complex that occupies more than an entire square block, with one-half of that space used for parking of trucks, employees' cars, and a large lawn. In fact, based on assessment records, the new post office, an exempt property, occupies the most valuable single piece of downtown real estate.

The response of the local government to decline is also evident in the extent to which tax abatements were used to lure investors back into the CBD. With few exceptions new office and hotel complexes received tax abatements that in most instances substantially reduced the taxable value of improvements. In large part, such complexes have meant the demise of older structures which simply could not compete against the newer subsidized units. Furthermore some 200 properties have non-profit tax exempt status. Although many of these are hospitals and churches which always have had such status, there are other non-profit groups which have been induced to locate in the downtown area. Some of the vacated sites have been directly taken over by the local government and transformed into grassy malls or used to build a new municipal center. Other vacated properties have been purchased by wealthy local residents and donated back to the city for public use.

The end result of all of these private and public sector adjustments is a central business district that is relatively underdeveloped and thus not very receptive to a tax that emphasizes land value. The value of the land controlled by the government and exempt from taxation amounts to about 20 percent of the land base with the ratio of improvements to land for such sites only 2.71. Non-government, non-residential private sites have a ratio of improvements to land of 4.09. Exemptions reduce this to 3.14. Indeed, older residential sites surrounding the CBD are more intensively developed on the average than the average non-residential property. Such older residential properties have an average I/L ratio of 6.53 before exemptions and 5.28 after exemptions. Under these circumstances a site tax even confined to the CBD and surrounding properties will evoke great opposition and will be politically unsupportable.

The study of site value taxation performed on South Bend was intended to look at taxing options to finance a personalized rapid transit system servicing the CBD. Site value taxation seemed an attractive option since any economic development effects of the transit system would ultimately work their way into land values. Yet given the adjustments to decline that had already transpired, the pre-economic development impact of a site tax was to increase the tax bills of many taxpayers. In fact, the shift to a site value tax increased the tax bills of more than 2,000 of the about 4,200 nongovernment sites, with the average bill increasing by \$1,679 per million dollars of total revenue shifted from the property to the site tax. Some of the largest losers are properties which have an exemption that applies to improvements and would not be allowable with a site tax. On the average, the losing properties have, after exemptions, a ratio of improvements to land of just 1.12.

Recalling the earlier discussion of winners and losers from a site tax, the effects of decline were to move many taxpayers in the CBD from category A,

winner from the tax instrument shift, to category C, loser from the shift. Although some evidence did emerge that a few property owners whose tax bill would be higher after the tax might, nonetheless, support the site tax because of economic development gains, (*i.e.*, those in category B) not very many owners seemed to fall into this classification. Furthermore, those with exemptions potentially jeopardized by the site value tax pose a political obstacle that is not easily overcome.⁹ Indeed, their very lack of support is probably enough to kill any chance a site tax might have of being adopted.¹⁰

VI

Discussion and Conclusions

THE PURPOSE OF THIS PAPER rests on showing that, in spite of all the favorable aspects a site value tax might offer when compared to the current property tax, the interaction of political interest and the adjustments to economic decline lessen the likelihood that a site value tax will be an acceptable alternative to the current property tax system. Initially, I had hoped that this might be demonstrated theoretically by combining a simple political model of winners and losers from a site tax with a model showing how an exogenous change which suburbanizes the population (*e.g.*, a change in transportation technology, a change in income, a change in taste, etc.) alters the intrametropolitan pattern of land prices and the distribution of improvements to land ratios.

The hope was to prove that the number of losers from a revenue-neutral site value tax would be an increasing function of the degree of suburbanization. This was not possible to demonstrate theoretically. Key response rates become data that determine how the pre- and post-suburbanization ratios of improvements to land actually change. Nonetheless, some information available on these response rates made it possible to formulate a likely scenario based on the theoretical model. That scenario was further refined by considering local government reactions to a declining central city and a declining central business district.

The primary conclusion that emerges from the scenario is that suburbanization will result in improvements to land ratios that move in such a way that many sites in the central city, particularly those in the central business district, will experience higher tax payments because of a site value tax. Therefore, opposition to a site value tax by an important group of politically influential land owners will be very strong. The responses of local government to decline further lessen the chances a site value tax will be adopted. The case study presented above demonstrates the validity of many of these conclusions. Nevertheless, the ultimate question of the model's generality cannot be answered without additional ev-

idence. Three types of evidence are important. First, more information is required on how the geographical distribution of improvements is affected by the degree of suburbanization a city experiences. Second, estimates of the substitutability of improvements for land in response to changing land prices are also vital. Finally, more information is needed on the responses of local governments to decline, particularly with respect to tax exemptions granted and their effect on improvements to land ratios.

If such studies do substantiate the theoretical and empirical conclusions reached in this study, they would help explain the reluctance of many cities to consider site value taxation as a viable option. Moreover, they would also indicate that while the taxing of unrealized capital gains may hinder the acceptability of site value taxation in some cities, in many other cities the obstacles confronting site value taxation may be of a totally different nature. Supporters of site value taxation then need to design strategies that overcome the bias against this taxing option that results as a by-product of economic decline.¹¹

Notes

1. The analysis in this section draws heavily on the works of Buchanan and Brennan and Buchanan, especially (Brennan and Buchanan, 1986; Buchanan, 1987).

2. See Edwards, 1984; McGuire, 1985; Pollock and Shoup, 1977; Rybeck, 1977; and Smith, 1978.

3. Two assumptions about the site value tax are used throughout the paper. First, the site tax will be applied to the assessed value of land just as the current system applies the property tax to the assessed value of land and improvements. Second, the control over adopting the site value tax will be at the level of the city. Although the state may enact enabling legislation, the city will make the final choice. This is the framework Pennsylvania has adopted which allows cities the discretion of applying different tax rates to land and improvements.

4. To be completely correct, the land price gradient should be an exponential function of the form $P_L = P_0 e^{-\alpha s}$ where s = distance. The analysis in this paper is unaffected by the use of the simpler linear form, however.

5. Although other exogenous changes, such as increased per capita income, lead to essentially the same result, evidence obtained by Muth (Muth, 1973: p. 199) indicates that automobile ownership is by far the most important.

6. The approximation results from two sources: 1) the use of a linear versus exponential function as mentioned above, and 2) a city may not be circular as the formula assumes. Note that the formula is based on the formula for the area of a cone.

7. Using a constant elasticity of substitution (CES) production function, the optimal ratio of improvements to land for the i th property is given as

$$I/L = (a/1 - a)^{1/(1+e)} (P_I/P_L)^{1/(1+e)}$$

where $1/(1 + e)$ is the elasticity of substitution between improvements and land in response to a change in their relative prices.

8. Properties outside of the core are mostly residential. In the case of single family residences the options in terms of improvements to land are somewhat limited. For instance, seldom does one find three story homes and it is even rarer to find a home of four or more stories. Residential

zoning requirements may also limit options as to alternative uses of land that is located beyond the central business district.

9. At least one recipient of a major tax exemption had in earlier discussions of the site value tax voiced his concern that a site value tax would hurt the small businessman. Somewhat paradoxically, the same individual could not understand concerns raised about the prospect that small businesses would bear some of the cost of the subsidy he had received or that such a subsidy might drive out other unsubsidized concerns.

10. The local government also has something to lose from site value taxation. Properties purchased by the government under urban renewal and resold after the imposition of a site value tax would suffer a capital gains loss equal to the capitalized value of the tax. As a holder of that property, the government would bear the burden of that loss.

11. Lindholm appears to recognize the need to make site value taxation appear "fairer" when he argues that land tax exemptions be given to small homestead land-holdings (Lindholm, 1979: p. 353). While this would make site value taxation acceptable to residential owners, a much more complex strategy is needed for non-residential owners who currently have sizeable exemptions.

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Freedom Rests on Dissent

WITHOUT EXHAUSTIVE debate—even heated debate—of ideas and programs, free government would weaken and wither. But if we allow ourselves to be persuaded that every individual, or party, that takes issue with our own convictions is necessarily wicked or treasonous—then we are approaching the end of freedom's road. . . .

As we preach freedom to others, so we should practice it among ourselves.*

DWIGHT DAVID EISENHOWER

* President Eisenhower's remarks at the two-hundredth anniversary of Columbia University, May 31, 1954.