

On Modernizing Local Public Finance:

Why Aren't Property Taxes in Urban Areas Being Reformed into Land Value Taxes?

By DICK NETZER*

ABSTRACT. *Urban economists* tend to agree that *land value taxation* is both equitable and efficient. Then why won't American *urban areas* reform their *property taxes* into a land value tax? One explanation may be that the climate of opinion is that the *taxation of wealth* is wrong. This may be another of the legacies of the *Great Depression*. In the 20 years preceding, levels of property taxation increased very substantially; this was associated with rapid *urbanization* and big increases in *public expenditures*. Even with the collapse of property values urban governments extended expenditures and hence taxes on *real property*—as they did again with *inflation* in the 1970s. But in the 70s residents were predominantly owner-occupants—a result of *counter-depression policy*. Their hostility to taxing unrealized *capital gains* is the obstacle advocates of land value taxation have to overcome.

I

I THINK MY TOPIC was meant to be provocative, and I hope it will be. I will not deliver a learned address, nor go back to the writings of Henry George to discuss the topic of land value taxation. Instead I start with the premise that in fact there really isn't very much wrong with land value taxation in concept. I want to talk about the issues in current context; the context, that is, of the United States, in the 1980s—a basically urban society.

Now urban economists, more than mainstream economists, tend to agree with the proposition that land value taxation is both equitable and efficient. In fact, a fair number of urban economists now subscribe to the proposition that the only appropriate way to finance local governments efficiently in a society such as ours is by a combination of land value taxation and user charges for services that have identifiable beneficiaries and therefore can be appropriately financed through some kind of public pricing. The question then is, if the land value tax is ideal, and if it has been persuasively advocated, with the kind of eloquence you find in the works of Henry George, why is land value taxation for all practical purposes absent from the United States?

* [Dick Netzer, Ph.D., is professor of urban economics and director of the Urban Research Center, New York University, 4 Washington Square North, New York, N.Y. 10003.] An address presented at a conference on March 8, 1983 held by Pace University in New York under its Henry George Research Program, funded in part by the Robert Schalkenbach Foundation.

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I know that there are a few isolated cases in this country where there is some form of land value taxation. But, by and large we live in a country which has decisively and repeatedly over the years rejected urban land value taxation to finance any level of government, including local governments. In fact, the country has decisively rejected even the idea of taxing land values equally with buildings. We have differentially heavy taxation of improvements in almost every jurisdiction in the United States, the opposite of what I think most people here would prescribe. There has to be something wrong with urban land value taxation in some way, conceptually or practically, otherwise it surely would have been more widely adopted by now.

After some searching for the answer to this paradox, I think I have finally found it. The answer starts with a rather fundamental change in the perception of what is appropriate, what is fair, what is moral in taxation between the 19th century and today. We live now in a climate of opinion where the taxation of wealth as such, rather than income or expenditure, is basically considered wrong by most people. That was not true in the 19th century when Henry George wrote. The issue that he was addressing is—shall we tax wealth that is created by man or shall we tax personal wealth that is generated by land rents? But, the problem we are dealing with now is the perception that the taxation of wealth is wrong, no matter how that wealth is generated.

But, in the 19th century taxation of wealth was considered a pretty good idea—the only taxation that existed in the United States at the time was state and local property taxes, (aside from import duties and taxes on alcoholic beverages) and these were justified as taxes on all forms of wealth. If my analysis is right, then there was some point at which the change in perception occurred.

II

HOW DID THIS COME ABOUT? In large part the change, like so many other things that we see in this country in the 1980s, is yet another one of the legacies of the Great Depression. The Great Depression was preceded by a twenty-odd year period in which there was a very substantial increase in levels of property taxation in the United States associated with rapid urbanization and big increases in public expenditures.

In the thirties, as we know, there was a collapse in property values, as well as in income. And, in the early thirties, of course the local governments did not conclude that there was no wealth left to tax. Instead, they observed the ostensible taxable wealth on the assessment rolls and extended taxes against that ostensible wealth. Of course, there were huge delinquencies, among

farmers and among the large numbers of people with modest income who in the 1920s had recently become homeowners. The results were aggressive movements in a number of states during that period to limit property taxes. In Florida there was a state referendum, which was defeated by a whisker, which would have abolished the property tax totally in that state.

The property tax subsequently was reprieved by rising real incomes. But in prosperity there were the seeds of serious political problems. During the fifteen years ending in 1981, there was an especially rapid rise in housing values, in a country now overwhelmingly dominated by owner-occupants of housing. This rapid run up in property values was far in excess of the increase in incomes. It produced vast unrealized capital gains, that is gains on the value of houses owned by people who had not sold them or had no intention of selling them, but who had huge gains on paper.

I believe that a considerable factor in the whole so-called revolt against property taxes in the United States in the 1970s came from the taxation of unrealized capital gains, particularly homeowners' unrealized capital gains. I think that Americans consider such taxation inequitable, harsh and entirely illegitimate with respect to owner-occupied housing. The size of the unrealized capital gains in the 1970s was really vast. I have made some estimates of the size of the increase in the value of existing unsold, unchanged, unaltered owner-occupied non-farm houses between 1969 and 1979. The total estimated increase in market value of owner-occupied housing (including land) between 1969 and 1979 was about \$1,500 billion, from roughly \$650 billion to \$2.2 trillion. Of that \$1,500 billion increase, about \$600 billion, about 40 percent of the increase, was in the form of unrealized capital gains. More than 25 percent of the market value of owner-occupied housing, as of 1979, consisted of unrealized capital gains. Many of the houses were those in which people had lived for many years and which they had no intention of ever selling. The very rapid run up in property values was fairly obviously associated with inflation, with the income tax preferences attached to owner-occupied housing, and with the fact that, until 1979, there were negative real rates of interest on home mortgages.

But this by itself should not have caused negative reactions by taxpayers: taxpayers are concerned with actual tax bills, not the way in which they are calculated. Why should there have been larger increases in tax bills? If property values were increasing very rapidly, much more rapidly than income, even more rapidly than rate of inflation in general, effective tax rates should have declined and actual tax liabilities for many property owners might not have increased very much at all. Tax liabilities might in some cases have actually increased by less than earned income.

In reality what happened was that many local governments were cheating. They used the increase in market values during this period, in many cases, to expand local government expenditure at rapid rates. Moreover, the situation was aggravated in those states where the property tax assessment system was reformed, with revaluations because of changes in state law and court decisions. This happened in the State of Massachusetts, where there were numerous increases in assessed values in many parts of the state during the 60s and 70s because there were revaluations going on even as market values rose rapidly. Local governments took advantage of this. They cut their tax rates by substantially less than assessed property values rose and expanded local government expenditures. This happened spectacularly in California, where house values are higher than anywhere else in the country.

So property tax bills in dollar terms rose very rapidly for many owners of existing unchanged property. Voters considered this illegitimate. In close to half the states, during the years between 1970 and 1980, voters through referenda or through legislatures put effective property limits on tax levies as well as on tax rates. Legislatures also enacted a variety of other kinds of tax preference arrangements, for farm land, for the elderly and for other purposes. I view much of this as a strong reaction against the notion that it is legitimate to tax wealth, if that wealth is in the form of unrealized capital gains.

III

NOW THE RELEVANCE of this to land value taxation is obvious. Land value taxation, by definition, is taxation of a form of wealth, and it necessarily involves taxation of unrealized capital gains. Henry George told us eloquently of the appropriation of the increase in productivity of labor and capital by passive land owners, who sit, hang on, and realize their capital gains many years later. It's an inherent characteristic of land value taxation to tax unrealized capital gains. It would defeat some of the very real advantages of land value taxation to substitute for annual taxation of capitalized land rents such alternatives as land value increment taxes on land that is sold, or other taxes triggered by transfers. That tends to discourage transfers, reduce the fluidity of the market and reward the land hoarder.

Those of you who are convinced Georgists have no problem with the concept of taxation of unrealized taxable gains in this form. Neither do most economists. Most economists think that wealth is wealth, and the fact that it hasn't been realized by sale doesn't mean anything at all. You can borrow against that wealth. You can consume on the basis of having that extra wealth. But I think we are peculiar. Our fellow Americans do have a problem with

the concept of taxation of unrealized capital gains, and we have to worry how to overcome that problem.

Now it is possible that changes in the external circumstances will help. The decade of the 1970s was a freakish one, I believe. We are not likely to see the kind of capital gains in housing values that we had in the 70s again. It is almost impossible to imagine a scenario in which there are negative real rates of interest on home mortgages (except very temporarily) ever again in American society. So huge unrealized gains are improbable. That should reduce hostility to land value taxation. On the other hand, there are numerous American cities in economic difficulty; in real terms, the market value of taxable property in those places declines faster than real income declines. In such circumstances, stiff taxes based on the value of land are not likely to be acceptable, especially since some of the precipitously declining land values are those of the land underlying owner-occupied housing.

I do not think we can count on ready public acceptance of land value taxation even if the 1980s are unlike the 1970s. I don't have any real solutions to the problems I have posed. Most Americans think that land value taxation is in essence unjust, not because they see land value taxation itself as being unjust, but because it is a form of taxation of wealth in the form of unrealized capital gains. I think it is proper to face this problem head on, which has not been done. Instead, advocates of land value taxation wax eloquent about the wondrous consequences for us collectively of switching to a tax that is in reality feared and loathed by most American voters as individuals.

What's wrong with land value taxation, in my view, is that the advocates have yet to find ways to persuade ordinary Americans that their conception of tax justice is just plain wrong. Economists have nothing to offer here. We need some exceedingly persuasive moral philosophers. Perhaps what we need is the Henry George who can address Americans as they are now, in the circumstances in which they find themselves, and with their beliefs as they are in the 1980s.

New Ideas for Economic Research

THE ATLANTIC ECONOMIC SOCIETY, one of whose objectives is to increase the opportunity for exchange of new ideas around the world, will hold an international economic conference at the University of Rome on March 9-16, 1985. For information, write Professor John M. Virgo, Southern Illinois University at Edwardsville, Box 101, Edwardsville, IL 62026-1001.