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HIGHER TAX RATES ON LAND THAN IMPROVEMENTS

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THE TAXATION OF LAND VALUE

An evaluation of any tax may be based on its efficiency, the amount of distortion it causes in economic activity, its equity and its administrative cost. The taxation of land, or site, value has been judged excellent on efficiency, good on equity and mediocre on administrative grounds. When compared to a general property tax, land taxation is usually considered either equal or superior on each of these criteria.

Land taxation has long been considered essentially the only efficient method of taxation. Since the supply of land is virtually unalterable, its taxation will not decrease (nor increase) the amount of land in the tax base; it cannot flee a local jurisdiction. Thus no distortionary effects result from the taxation of land. Additionally the taxation of land is a clear signal to landowners to develop their land to its full potential. Thus land taxation may be the one tax that supply-siders could learn to love.

Some recent theoretical inquiry has concluded that land taxation dynamically distorts the timing and extent of land development. This bias is toward earlier development of land with less intensive improvement than would have occurred without the land tax. These conclusions are new and have not been generally accepted.

The equity of any tax is always arguable, since different values lead to opposing evaluations of the same tax. However some observations can be made regarding fairness with respect to land taxation. With the exception of exemptions and abatements, owners of equivalently valued land pay equal taxes. Since the ownership of land is concentrated more in high-income groups, a proportional tax on land value is progressive in its incidence with respect to income. Furthermore the land tax is borne by the landowner; it cannot be

shifted to labor, owners of capital or consumers because of its supply inelasticity. Since a land parcel's value (particularly in urban areas and except for extractive purposes) is determined mainly by its location and is created largely by forces other than the activity of its owner, the taxing of land values does not tax the landowner's efforts.

The administrative costs of land value taxation are more problematic, given its limited usage. It is not unreasonable to assume that these costs would be comparable to those of the property tax, which are low except for small jurisdictions. Conceptually there are few problems with assessing land value. However in practice there are formidable difficulties brought about by the small number of market transactions in unimproved land, which are necessary for defining and isolating the various characteristics of land that determine its value. Thus the accuracy of the assessment of the tax base for land value taxation is probably substantially less than for income or sales taxes, although the precision of the latter two is becoming more questionable. The use of modern computers and statistical techniques is reducing the costs of administration and increasing the quality of land assessment.

DECREASING IMPROVEMENT TAXES AND INCREASING LAND TAXES

Increasing taxes on land value and decreasing taxes on improvements will result in increasing the quantity of improvements, whether as an incentive to new construction, to rehabilitation of existing structures or to earlier development of vacant sites. This construction expansion occurs because the tax on buildings discourages construction to its full potential and a land tax either prods owners of underdeveloped parcels to increase improvements or may encourage earlier development of vacant land. One study estimates that the

effects of a complete change from the property tax to a land value tax will be to increase the long-run investment in improvements to land by up to twenty-five percent. Although initially land values will fall because of the capitalization of the increased tax into its value, the long-run increased development of land from the decreasing of taxes on improvements and increasing the taxes on land is projected to result in a net increase in land values. In one study of a total change to land value taxation, estimates of this positive net effect on land values were statistically derived.

The redistribution of tax burdens among different properties resulting from this change is less clear. One certain result is that properties with a higher than average ratio of assessed improvements to land values will experience a decrease in property tax payments. How this ratio is distributed with respect to type of property, location of property and income of recipient will depend substantially on local conditions and thus varies among jurisdictions. Some of the conceptual issues involved with the incidence of the property tax are not well understood, which leads to more uncertainty as to the reliability of these estimated results. Furthermore since within each property type there are parcels with widely differing characteristics, redistribution results will differ substantially for individual properties within each property class.

However some generalizations can be made about average changes in tax burdens resulting from a change to a differential property tax levied more heavily against land, when no changes are made in assessment practices and total tax revenues are kept constant. Since the average of the ratio of improvement to land value for small residential properties is usually greater than the overall average for a jurisdiction, the average property taxes for these types of properties usually decreases. Property types which on average

show an increase in tax payments are those which use land less extensively or are situated on particularly valuable sites, such as garages, theatres, stores, restaurants and, of course, vacant land. Properties that are sited at valuable locations, unless extensively developed, and parcels with little improvement value will probably experience property tax increases regardless of their classification. The converse applies to locationally inferior and extensively improved properties.

These generalizations apply only to the initial impact of a change to a graded property tax. To the extent that these tax payment differentials are capitalized into property values, that is, become part of property values, the initial tax changes will be mitigated, although the direction of change will not be altered. However the incidence of the property tax, that is, who finally pays the tax, not who is legally liable for it, also determines the final distribution of tax payments and this topic currently is subject to dispute. A study which attempted to take account of these capitalization and incidence effects concluded that their results were dependent on the incidence assumptions used. Since those incidence assumptions are problematic, the longer term changes in tax payments are not predictable with confidence.

Undoubtedly some capitalization of tax changes will occur; it will cushion the impact of this policy change on tax burden shifts but will also lead to changes in property values. The capitalization effect on property values will be negatively proportional to the tax burden change, thus a large change in tax payment will result in, and be partially offset by, a large property value shift. The property value changes will be substantial in some cases, particularly for vacant land. Any precipitous change in either tax payments or property values can be ameliorated by various policies, for example, a phase-in of the new tax payment.

The cost of administering a differential property tax should be no greater than the cost of administering the present tax, since land values are already separately assessed. Land value estimates should be more understandable to and comparable by property owners. It is probable that current land assessments are less accurate than those for improvements, so the overall quality of assessment should initially decrease. However the use of more sophisticated valuation techniques would substantially eliminate this problem. Land value estimation depends on fewer parameters than property value estimation, but unimproved land (in urban areas) is also subject to fewer market transactions. Thus the comparative administration of the best assessment of land relative to total property value is both complex and not easily determined.

SUMMARY

The taxation of land value is an appropriate revenue source, particularly for local governments. It is efficient, arguably equitable and administratively manageable. A change to a differential property tax with a higher rate of taxation on land than improvements will lead to more intensive development of real property. It will also lead to redistributions of tax payments and property values, which can be assuaged with the appropriate policies, with lower taxes initially for properties that are relatively intensively developed. It is essentially no more problematic to administer than a property tax with undifferentiated rates.

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