

IRRATIONALLY INDISCRIMINATE TAX

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Most homeowners need to become aware that in addition to the house, their property includes the plot of land that contains the house. The two components of the property are very different and should be taxed at different rates. A pertinent slogan is "Tax bads not goods." The house is an asset for the owner and the community. A low tax rate is rational because it decreases the future cost of desirable behavior by the owner. The land is not constructed and does not depreciate. Its value depends on the population and facilities of the neighborhood. A vacant or underdeveloped plot in a city is a liability for the community. A high tax rate on land value is a rational source of support for the city.

All human decisions are responses to motivations and goals. Rational policy was the motivation, and economic development was the goal for the lower tax rate on buildings than land in Pittsburgh, beginning in 1914. Irrational motivations and misguided goals explain the shift to the same tax rate on buildings and land in the same city in 2001.

The indiscriminate tax was precipitated by reassessment of all land and buildings in Allegheny County in 2000. The irrational taxation was demanded by homeowners who did not understand the purpose of the differential tax rates. Consequences of the indiscriminate tax rates can be predicted. The events and reactions offer guidance on how the differential tax rates can be restored.

Property Reassessments

The reassessment of property by Allegheny County was in response to a court order. The assessment firm, Sabre Systems and Service, emphasized valuation of the house. Detailed attributes of the building were recorded. Valuation of the land was a less precise residual criterion, obtained by subtracting the value of the house from the value of the property.

The new assessed values were announced during a span of several months in the second half of 2000. Preliminary notifications reported the total reassessed value of each property, without distinguishing between the building and the land site. A World Wide Web site contained the information on the attributes of the building and the reassessed value of each property. The information on each property was accessible to everybody who had the necessary computer equipment.

The Pittsburgh tax rates in 2000 were 184.5 mills on land, 32 mills on buildings. This ratio of almost six to one had been the same for the last several years. The millages were based on 25% of market value. The new assessments changed to 100% market value, for which the equivalent rates were 46 mills on land, 8 mills on buildings.

The higher total property values required reduction in tax rates because of a Pennsylvania State law that tax revenues could increase by no more than 5% per year due to higher assessed values of property. The tax rates for 2001 proposed by Mayor Murphy and accepted by the City Council, 31.67 mills on land, 5.44 mills on buildings, retained the former ratios.

Demands for Indiscriminate Tax Rates

Many homeowners protested. Most reassessed values were increases over the year before, but some were only modestly higher while others were more than doubled. Inspections of the assessment Web site revealed anomalous assessments. Some neighboring houses had very different assessed values. Some of the comparable houses designated for each property were several blocks away rather than in the same small neighborhood.

Near the end of 2000, the City mailed to each homeowner the statement of what the taxes would be in 2001. This was the first time the property owners were informed of the separate assessments of land and building. For most properties, the assessed value of the land was much higher. The assessed value of the building was usually slightly lower.

The annual Pittsburgh tax bills previously itemized separately the assessed values and differential rates for land and buildings. Most homeowners did not inspect them attentively. In the tax bills for 2001, the prevalently higher reassessed value of land was associated with a tax rate almost six times higher for land than buildings. The slightly lower reassessed value of the house was associated with a much lower tax rate. Reactions by property owners included objections to the higher tax rate on the component of their property that had become more valuable. The most numerous and effective complaints were from homeowners in the wealthiest residential sections of the city, Shadyside and Squirrel Hill. They did not want to recognize that their land values previously had been greatly underassessed. A seemingly obvious remedy was replacement of the "bifurcated" tax rate with a "unified" rate. The differential tax rates were characterized as confusing and as contrary to the unified tax on land and buildings in most other cities. These complaints expressed a human tendency to rationalize irrational objections. The homeowners would not have complained if the large increases in assessed values had been on their house rather than on their land.

Other objectionable features of the reassessments resulted from their emphasis on the value of the house rather than the land. A vacant lot is assessed at a lower value than an equivalent lot that has a building on it. Part of the building's value is assigned to the land. Because the land value units are large districts rather than specific neighborhoods, the wealthiest neighborhoods are underassessed and the relatively poor neighborhoods are overassessed. Calculations of assessed land values per square foot reveal that in the same neighborhood, larger lots are underassessed while smaller lots are overassessed. Rich owners of large lots therefore obtain tax relief while poorer owners of small lots are inflicted with heavier tax burdens.

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The majority of City Council members forced Mayor Tom Murphy to accept a single millage rate of 10.8 on buildings and land. The leading advocate of the indiscriminate tax was Bob O'Connor, the President of City Council. He is competing with the incumbent for the Democratic nomination for Mayor in the Democratic primary election on 15 May this year. The winner of the primary election is virtually guaranteed election in November for a four-year term.

The total property taxes have obscured the beneficial effect of the lower tax rate on buildings than on land. Homeowners in Pittsburgh pay the same tax rate on land and buildings to Allegheny County and the Pittsburgh School District. The beneficial effect of the differential tax rates in Pittsburgh has been counteracted by prevalent underassessment of land. In 1996, the Commissioners of Allegheny County cut real estate taxes by 20% and announced a freeze on assessments for the next five years. Each year, the frozen assessments became more severely too low on land, too high on buildings.

Predicted Consequences of Indiscriminate Tax Rates

The Pittsburgh tax rate of 10.8 mills in 2001 is less than a quarter of the prior rate of 46 mills on land, adjusting for the change from 25% to 100% of the market value. The annual cost of owning a vacant lot therefore is greatly reduced. The cost is further reduced because the reassessments systematically underassess land that is vacant in comparison with an equivalent plot of land that contains a building. A low cost of holding a vacant lot is detrimental for the neighborhood and city. Larger amounts of land will be kept vacant. Other land in the same neighborhood therefore will become more scarce and expensive. The market value of the vacant lot will increase because of the decreased cost of keeping it. This is beneficial for the owner but detrimental for potential buyers and developers. The city's tax revenue will be depressed by larger amounts of vacant land, taxed at a low rate.

The tax rate of 10.8 mills in 2001 is higher than the prior rate of 8 mills on buildings, adjusting for the change from 25% to 100% of the market value. This appears to be a small difference, but it aggravates the detrimental effect of the larger decrease in tax rate on land. Construction and improvement of buildings will be retarded. The higher taxation cost persists every year thereafter until the building is demolished or completely depreciated.

The adverse consequences of the indiscriminate tax will probably be most evident in the downtown area. The prior lower tax rates on buildings than land contributed to the construction of several very large, expensive buildings downtown. The value of a tall building is much greater than of the land that it occupies. The taxes on these properties will be much higher. Some members of Pittsburgh City Council argued that the indiscriminate tax will force the wealthy owners of the tall buildings to pay their fair share of taxes. The occupants of the tall buildings are renters. The absentee owners will pass on the

taxation cost to the occupants in the form of higher rents. The owners will be increasingly able to obtain higher rents, because the higher tax on buildings retards new construction and therefore generates less competing rental space. The city's economy will be retarded by the higher rents. The city's tax base will shrink. New buildings will be fewer and smaller. Each year the buildings will be older and further depreciated.

These adverse effects might not be immediately obvious. Also, they are counteracted by the reassessments, which generally increased the values of land and decreased the values of buildings. The city initially might appear to benefit from the indiscriminate tax rate. A further deceptive effect of retarded construction and low tax rate on land will be higher market values of property. The owners will be glad that their property is more valuable. Their gain is the community's loss. It will be more difficult for new people to buy property they need for residence and business. The city's population and prosperity will decline.

How to Restore Differential Tax Rates in Pittsburgh

The change in assessed property values was large and sudden. The change from differential to indiscriminate tax rates also was large and sudden. The reassessments are being reexamined. This unstable situation provides an opportunity to restore the lower tax on buildings than on land.

In recent years, more than a dozen municipalities in Pennsylvania have enacted lower tax rates on buildings than land. The differential tax has generally been reported to stimulate construction of buildings, in accordance with the intended effect. Three of these municipalities with lower tax rates on buildings than land, McKeesport, Duquesne, and Clairton, are in Allegheny County and therefore experienced the same reassessments. The lower rate on buildings than land was continued in 2001 in all three municipalities. In Clairton, the increase in assessed property values enabled a decrease in millage on buildings to a very low level. Research on the effects of the indiscriminate tax in Pittsburgh should include comparisons with these three other municipalities in Allegheny County. Although Pittsburgh is a much larger city, the comparisons may show contrasting changes in building permits, rental costs, number of vacant lots, population, and other measures of growth and prosperity.

The prevalently higher reassessed values of land, in conjunction with the higher tax rate on land than buildings, might have caused an invalid assumption that an indiscriminate tax rate would decrease the property tax of homeowners. Most homeowners have a house that is well maintained and valuable, on a small plot of land in a residential neighborhood where the land values are modest.

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Residential apartments are in an expensive building, where owners on different floors share a small proportion of the land. Research after the reassessments might demonstrate that their property taxes will be lower if the city collects the same total tax by a decreased millage on buildings and an increased millage on land. Many commercial properties are vacant lots or contain a cheap building, such as a gas station or a shed on a surface parking lot. A rational response to the lower tax on buildings than land by owners of commercial properties is exemplified by the large buildings downtown.

A critically important purpose is to inform homeowners, other voters, and politicians on the difference between buildings and land. Different types of property should be taxed at different rates. A commendable and beneficial policy of Allegheny County is to make the assessed property values accessible to everybody on the World Wide Web. The public is thereby better informed on the distinction between land and building values. Most of the complaints have been against inconsistent and erroneous assessed values rather than against the general increase in assessed values of land instead of buildings.

Homeowners will accept higher assessed values together with higher tax rates on their land if they believe that the assessments are accurate. The quality of assessments therefore is very important. The assessors need to divulge all of their criteria and mathematical formulas. Property owners then can reproduce and either accept or correct the assessments on the basis of objective attributes of the land and buildings.

Assessments need to be kept up to date. A long interval after the prior assessments accounted for the drastic change in the reassessments last year in Allegheny County. The indiscriminate tax in Pittsburgh in 2001 probably would not have occurred if the reassessments had been followed by a gradual instead of immediate change in the property taxes. A preferable policy is to update the assessments systematically every few years. Market prices of properties can be used to update assessments more often. Each sale of a property should modify the assessed values of the neighboring properties in addition to the assessed value for the new owner.

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