The Property Tax

No matter how widely and efficiently user charges are employed, a major role will remain for local general taxes as a source of funds for public services, especially if intergovernmental fiscal arrangements continue along existing lines. The dominant local tax, producing over 85 per cent of local government tax revenues, is the property tax. There are nearly 71,000 local government units using the property tax, nearly 18,000 of them in metropolitan areas, with diverse tax bases, tax rates, and expenditure needs. The tax finances the overwhelming bulk of the local share of school costs and a major fraction of the local share of most other governmental activities.

The property tax suffers from numerous disabilities. The disadvantages might not be serious if the tax were a minor one, imposed at low rates. But it is not minor. In urban areas outside the South, property tax bills frequently average more than 2 per cent of the *market* value of taxable property and in the larger central cities, particularly in the Northeast, rates in excess of 3 per cent are not uncommon. This may not sound high, although it is by historic standards. However, property taxes in the large urban states are equivalent, in revenue yield, to a flat rate tax on personal income (after personal exemptions) of 10 per cent or more. Some of the disadvantages of the property tax are inherent in the tax itself. Others stem from its use by so many small local government units within a single metropolitan area, and might be mitigated if the tax were imposed at uniform rates over wider geographic areas, such as whole counties.

In the discussion of policies affecting urban housing in Chapter 4, two of the most serious difficulties with the property tax were discussed at some length. One is its deterrent effect on the consumption of housing, largely a problem of central cities. To recapitulate, the tax is a high percentage of annual housing costs to consumers. Considered as a sales tax, its rates in urban areas are equivalent to sales tax rates of 25 per cent or more, far higher than the sales or excise tax rates applied to most other forms of consumer expenditure. For homeowners, especially well-to-do ones, the tax is offset by federal income tax advantages. Moreover, the property tax on suburban housing is clearly linked to the services it finances. But renters have no offset, and in central cities the property tax–public service linkage is a very obscure one. The property tax in central cities, therefore, imposes a serious impediment to the needed rebuilding of the central-city housing stock, an impediment that is increasing, not decreasing, with time, as property tax rates rise. There is much evidence that, in the large central cities, property tax rates have been climbing steeply during the past decade.

A second difficulty discussed in Chapter 4 is the incentive that heavy reliance on the property tax makes for "fiscal zoning"—to control land use to maximize the tax base of each of the many small suburban governmental units and to minimize public expenditure requirements. The latter is done by "zoning out" moderate-income families likely to have large numbers of public school children, principally by requiring large minimum lot sizes. This raises land costs for housing in a metropolitan area. It also leads to a highly dispersed development pattern with increased transportation and utility costs.

Fiscal zoning is unlikely to eliminate disparities in property tax bases among local government units. Indeed, its frequent effect is to reinforce them and to further enhance the fiscal position of the community with large amounts of taxable property per resident or per pupil. One consequence is the effect on the choice of location within a metropolitan area. Clearly, one would prefer to live in a community able to provide very generous services per dollar of property tax paid by a resident; the prices of houses may be higher in such a community, but not as much higher as the property tax advantage would suggest.

Also, there is an impact on the choice of location by businesses. Firms are not likely to move long distances in response to local tax differentials, for differentials in other business costs are much more important. However, within a metropolitan area, these other business costs tend to be similar in many alternative locations. Wage rates, water and energy costs, and costs of transportation of raw materials and finished products do not vary greatly within a metropolitan area. Thus, tax differentials may be the *only* significant cost differentials and some firms will respond to these differentials, by moving to the low-tax jurisdiction, further enhancing its fiscal advantages.

One general effect of this is to discourage communities from increasing tax rates to finance improvements in public services, lest they discourage industry from locating there.[5] Another effect, found less frequently, is that part of the business property tax base, located in low-tax places with few school children, is effectively sterilized for school tax purposes. In the extreme cases, where there are industrial enclaves with few residents, the industrial property is in effect tax exempt for school purposes.

Local tax differentials can also reinforce the one situation in which other business costs do vary significantly within metropolitan areas. For many kinds of goods-handling activi-

5. It is often asserted that this will not occur, since industry is sensitive to differences in public service levels. This may be true among regions, but probably is not within a single metropolitan area. The principal property-tax-financed service is education; a firm's employees can live in an adjacent high-tax community with good schools while the plant is located in a low-tax community with poor ones.

ties, the central cities have serious cost disadvantages, with regard to land availability and congestion. Major local tax differentials can accelerate the migration from the central city to outlying areas. In the Northeast, such tax differentials in favor of the suburbs are frequent. For example, the older cities in New Jersey have property tax rates that are two or more times as high as in the outlying areas.

Clearly, both the pressures for fiscal zoning and the locational effects of property tax disparities are not inherent in the property tax, but are a consequence of the fragmented structure of local governments in most large metropolitan areas. If area-wide taxes were used, for example to finance education (which absorbs over half of all property tax revenue), these deficiencies might disappear. They would also disappear if nearly all school costs were financed by statewide property taxation, as has been proposed in California, for example.[6] Similarly, any wholesale shift in school financing to the states or to the federal government would work in this direction.

However, as long as the property tax is a substantial one, some inherent defects will remain. One is that it is the most regressive of the major forms of taxation used in the United States. That is, its burden, as a percentage of income, is much higher for low-income people than it is for high-income people. This is principally because housing is so large a component of consumer spending for low-income families. This is less true on a lifetime basis (for example, many elderly low-income people live in housing acquired years earlier when their incomes were higher), but at any given moment the property tax is decidedly regressive. This has been repeatedly demonstrated by studies done for the country as a whole; it is

6. By Governor Ronald Reagan, in April, 1969. *The New York Times*, April 9, 1969.

even more true for individual cities and states. It is surely grotesque to finance public services with a major income-redistribution element by means of a tax that partly offsets the intended redistribution.

Another inherent difficulty lies with administration of the tax, that is, assessment of individual properties for tax purposes. The true value of a parcel of real property is known only at the time that the property changes hands in a market sale in which both buyer and seller are willing and knowledgeable. At other times, assessors must guess, by looking at recent sales of similar property, or the income produced by the property, or the cost of constructing a similar building. Since each piece of real property is unique, at least in its location, it is not surprising that the best assessors can do is to come reasonably close, especially in large central cities, where the differences among individual properties are very complex.[7] This produces substantial inequities among individuals and hostility to the tax itself.

In view of all the defects of the property tax, why does it persist? In fact, it does more than persist; in recent years the percentage increase in property tax collections has been far greater than the percentage increase in gross national product. The fact that it does produce so much money is one reason why it persists. A second reason is that it is the only major tax reserved to the local governments, with income and payroll taxes heavily used by the federal government and sales taxes heavily used by the states. Local governments apparently feel freer to impose heavy property taxes than to add to state sales taxes or to impose high income tax rates, on top of federal, and in most places, state income taxes. In reality, this sug-

7. In contrast, someone's income or a store's retail sales are objectively ascertainable quantities, although they may be hard for the tax collector to discover.

gests an illusion—a greater willingness by taxpayers to part with money when labeled in one way than to part with the same amount of money when labeled in another.

The fact that real property is visible and can be discovered readily makes the tax more suitable for administration, however inadequately, by small local governments than, say, income taxes. Another aspect of the administrative problem relates to the existence of "layers" of local government existing in the same area: counties, municipalities, townships, school districts, and special purpose units. In the Chicago area, for example, there are more than 1,000 local units with property-taxing powers. The layers do not have boundaries that coincide in most cases, so that the residents of a community may be in different combination of townships, school districts, and special districts. It is not hard to compute total property tax liability for all these layers, since the real property itself has a geographic identity. To compute income tax liability for thousands of possible combinations would be far more difficult.

Land Value Taxation

It is clear that, aside from its revenue productivity, the positive attributes of the property tax are insignificant compared to its defects. There is one form of property taxation, however, for which an entirely different, and favorable, balance of advantages and disadvantages can be struck. This is the taxation of bare site values—the land alone, without any tax on the building on the site—an old idea vigorously espoused by Henry George a century ago. The land value tax is the economist's ideal: it is equitable; it is neutral in its economic effects; and it is positively desirable as a replacement for the conventional property tax with its many bad economic effects.

The argument for land value taxation, on equity grounds, is that most of the value of land is a consequence of investment in public facilities and utilities, community development and population growth, not a result of action by individual owners. The owners realize large increases in land values over time, increments that they do not earn by their own efforts. It is fair, therefore, that the community recapture these "unearned increments" by taxation and use them for public purposes.

Land value taxation is economically neutral in the sense that it does not change land-use incentives, compared to no tax at all, since changing the use of the land does not affect tax liability. The most profitable possible use of the site before the tax is imposed continues to be the most profitable use. But the present property tax, applying to both land and buildings is not neutral. The construction of a bigger or better building, or improvement of an existing building, increases tax liability. Therefore, the present tax tends to discourage investment in buildings.

A switch to exclusive taxation of land (or to heavy taxes on land and light taxes on buildings) could have strong positive effects by removing the disincentive to invest in buildings. Owners would be encouraged to develop sites more intensively, thereby securing a flow of income from which to pay the land value tax. In urban areas, taxes on vacant land would tend to rise, making it more expensive to withhold land from development. It is likely that a switch to land value taxation would encourage development most in two parts of a metropolitan area—in the central sections, on valuable sites where older and smaller buildings are now standing, and on the urban-rural fringe where landowners would be less likely to hold out for future speculative gains. Landowners would generally be under pressure to better utilize their land, or sell out to others willing and able to better use the site.

Heavy or exclusive taxation of land values is widely practiced—in western Canada, Australia, and New Zealand, for example. There is a renewed interest among economists, planners, and public officials in land value taxation for the United States. In part, this renewed interest is based on a closer scrutiny of some of the alleged defects. It has been argued that land values are not large enough to permit a complete replacement of the conventional property tax by the site value tax. It has also been argued that there are serious administrative problems.

The experience elsewhere suggests that the latter argument is invalid. In fact, it appears that assessment of land values may be easier to make than assessment of land and buildings combined. In regard to the former argument, a recent study indicates that 40 per cent of the market value of taxable real property is accounted for by the land alone, and that land values have been rising at about three times the rate of increase in the general price level.[8] If this is so, a land value tax at rates averaging slightly over 4 per cent nationwide would be sufficient to replace the entire present tax on land and buildings.

The very rapid rate of increase in land values in recent years makes this even more attractive, for it indicates that huge "unearned increments" have been accruing to landowners. Moreover, landowners tend to be relatively high-income people, a consequence of income tax, mortgage market, and other conditions. There is poetic justice in heavy land value taxation: at present, land is typically taxed at rates, relative to market value, that are less than half those applied to buildings. We now, perversely, favor the speculator

8. Allen D. Manvel, "Trends in the Value of Real Estate and Land, 1956 to 1966," in National Commission on Urban Problems, *Three Land Research Studies* (Research Report No. 12, 1968).

who impedes development and discourage the investor in new and better buildings.

Local Nonproperty Taxes

Outside the English-speaking world, local government is relatively unimportant, but it does exist and raise significant amounts of tax revenue in many countries, especially in Western Europe. And unlike the English-speaking countries, the taxes used are mainly *not* on land and buildings, but on income, sales, or business activity. Thus, the existence of local government does not necessarily require heavy reliance on property taxation, although such is the case in the United States.

Less than one-seventh of the tax revenue of American local governments comes from local nonproperty taxes such as income and sales taxes; excises on public utilities, liquor, cigarettes, and gasoline; and a variety of revenue-raising license taxes. This is, however, a deceptive figure for two reasons. First, some types of local governments, especially school districts and county governments, hardly use the nonproperty taxes at all; they are largely the province of municipal governments.[9] Second, local nonproperty taxes are not used in some parts of the country. General sales and income taxes, the most productive sources, are not used by local governments in twenty-seven of the fifty states.

General sales taxes are widely used by local governments in sixteen states; local income taxes are widely used in five states and by a small number of large cities in three others. With few exceptions, the very large cities use either sales or income

9. One implication of this is that nonproperty taxes contribute little to the financing of schools or of the functions in which the counties play a large role, like welfare. However, there is a trend toward increasing county government use of these taxes.

taxes; New York City uses both. The forty-three largest cities combined get nearly 40 per cent of their tax revenues from local nonproperty taxes. In some of them, the local nonproperty taxes exceed the property tax in importance.

In some respects, the nonproperty taxes can overcome the disadvantages of the property tax. For one thing, they do not have the unfortunate effects on housing consumption characterizing the property tax in central cities. For another, they can be a lot less regressive than the property tax. Even without graduated rates, an income tax can be made mildly progressive in its incidence, if personal exemptions are permitted, as is done in Michigan cities. Usually, however, there are no exemptions and often property income (interest, dividends, and rents) is not taxed. This makes a local income tax somewhat regressive, but less so than the property tax.

The sales tax is frequently denounced as a highly regressive one, but this need not be the case. In fact, if food is exempt from the tax, as it is in some states, the tax is more or less proportional to income. This is because food and housing (exempt from sales taxation in general) absorb high percentages of the incomes of low-income people. However, even if food is taxed, the sales tax is less regressive than the housing component of the property tax.

Another advantage of the nonproperty taxes is that they can enable the central city to tap the wider tax-paying capacity of the metropolitan economy, by taxing sales to visitors and nonresident shoppers and, more important, by taxing the income earned by suburban residents in the central city. It should be noted, however, that there is some inequity in this. The central city has a fiscal claim on the whole metropolitan economy largely because of its services to the poor of the area who are concentrated in the central city. Ideally, all suburbanites, not just those who happen to work in the central city, should help defray the costs of these services. The commuters can be reached by the city's income tax; other suburbanites cannot. This solution then is expedient, if somewhat inequitable.

Nonproperty taxes, however, do share some disadvantages with the property tax. They too can have adverse effects on the location of economic activity, if tax rates are much higher in one location in a metropolitan area than in others. There is one rather striking example of this. Prior to 1965, New York City was a sales tax island, for there was no sales tax in adjacent New Jersey or in the surrounding suburban counties in New York State. A careful economic study indicated that the city's 4 per cent sales tax, by itself, was responsible for the diversion of nearly 25 per cent of the city's retail sales of house furnishings and apparel to suburban areas.[10] This in turn had serious effects on employment in retail establishments.

Also, local nonproperty taxes do not eliminate the problem of disparities in fiscal resources, although they mitigate this problem for the central city. Just as real property is unequally distributed among suburban communities, so are retail sales and personal income. For example, the community with a large regional shopping center could finance all its expenditure from a moderate sales tax, but its immediate neighbors might have only negligible sales tax receipts. A rich residential community would have a very ample personal income tax base, while its poorer neighboring residential communities might require exceedingly high income tax rates to finance their public expenditure requirements.

In summary, local nonproperty taxes appear to be a second-best solution, mainly useful for large central cities. Until and

10. See Henry M. Levin, "An Analysis of the Economic Effects of the New York City Sales Tax," in *Financing Government in New York City* (New York: New York University Graduate School of Public Administration, 1966), pp. 635–692.

unless intergovernmental fiscal arrangements are changed, the cities must do something to finance their requirements. The nonproperty taxes are, on balance, superior to further increases in the conventional property tax.

Conclusion

In criticizing existing fiscal institutions and discussing possible reforms—changes in intergovernmental fiscal relations producing a greater role for the federal and state governments; greater and more sophisticated applications of user charges; deemphasis of the conventional property tax and heavier taxation of land values—this chapter is not a quest for reduced taxes for individual taxpayers or the permanent resolution of fiscal conflicts in urban America. In fact, a greater role for higher level governments is likely to lead to more public expenditure and thus higher, not lower, taxes, on a combined federal, state, and local basis. If tax rates are rising, fiscal conflict will persist.

Instead, the goal has been to explore ways to help governments serving urban areas perform the functions that only governments can do, along two lines: through an improved framework for decision-making on public expenditure (handling spill-overs properly and using the signals given by the price system, in the form of user charges, to help guide public investment policy) and through the use of revenue sources with few toxic side-effects on housing, urban form, location of economic activity, and income distribution. Other specific reform proposals no doubt also satisfy these criteria; the purpose of the chapter has not been to advocate a particular set of fiscal policies but to illustrate the application of economic reasoning to the problems of financing urban government.

That, of course, describes the purpose of this book in general. A large number of policy alternatives have been reviewed; in many cases, the appraisal has been a favorable one. In some cases, the appraisal has been so favorable that phrases connoting a moral imperative, like "should be done" and "must be done," have been used. However, these are just one economist's findings. The book will have fulfilled its mission if it has succeeded in providing the reader with a different perspective on urban problems, that of the economist, and even more if it has stimulated the reader to challenge the reasoning that lies behind the policy findings. But in making the challenge, please keep in mind a few of the key elements of economics: the need for choosing the best among many desirable end-products; the importance of finding the most efficient means for achieving those ends; and the prevalence of interpendency, that is, the external effects that are ever present in public affairs. Remember that resources used for one purpose are not available for others; money is not real, but labor, land, buildings, and machinery are; it is usually desirable to enjoy benefits now and incur costs later; indirect ways of achieving goals have resource costs just as do direct ways.

Perhaps the most frequently overlooked and most insistently urged analytical argument of the book is this: existing institutions and policies have negative as well as positive economic effects on the resolution of urban problems. The mitigation of the harmful effects, by revising existing institutions, may be more important than any conceivable combination of glamorous and wholly new institutions, policies, and mechanisms. This is hardly a revolutionary prescription, but a society approaching universal affluence must be doing something right.