SHOULD BANKERS CARE ABOUT HOW MUNICIPALITIES, COUNTIES AND SCHOOL DISTRICTS TAX REAL ESTATE?

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Bankers have been in the business of making construction loans to developers and providing permanent mortgage financing to homeowners for a very long time. The extent of risk associated with real estate lending is no secret to the many bankers whose institutions became insolvent as borrowers defaulted after collapse of a real estate market. For bank loan officers the challenge is one of managing risk under circumstances where accurate forecasting of a market collapse has never been available. Making loans to developers based on appraised values is a high risk practice at the top of a land market's upward spiral. Analysts providing bankers with market information seldom seem to identify the leading indicators of a coming downturn, for the simple reason that they have an incomplete understanding of the underlying dynamics of how markets operate and how the vast array of public policies act to stabilize or destabilize market equilibrium. If there is insufficient attention to the impact of tax policies on markets, there is virtually no attention paid to the traditional form of property tax imposed by municipal and county governments and school districts.

There are excellent reasons why property improvements ought to be exempted from taxation and why land parcels ought to be taxed (and taxed up to an amount equal to a parcel's annual rental value). Moreover, there are excellent reasons why the banking industry should get behind efforts to achieve this change.

Let us first look at the reasons for exempting property improvements from taxation. The most obvious reason is that communities need and ought to encourage new construction and renovation of older buildings worth saving. Accounting rules permit owners of buildings to take depreciation expenses because buildings begin to lose economic value and functional utility from the moment they are completed and begin to be occupied and used. The older they become the faster is the rate of depreciation, the greater the investment of financial resources required to maintain condition and replace worn-out or obsolescent systems. The annual tax on the assessed (i.e., the supposed market) value of a building is an added cost that discourages expenditures for maintenance and systems replacement when cash flows from operating a business or leasing space to tenants are falling. Prudent real estate investors and bankers break ground for new construction or building renovation only when the numbers work, meaning that the forecasted cash flows are adequate to cover debt service, plus all other expenses, and still yield an adequate return on investment. The fact that so many municipal governments agree to relatively long-term abatements of all or a portion of the real estate tax obligation suggests that a general exemption would be an important change in the public policy externalities affecting real estate construction. An entire market exempted from the taxation of property improvements is a market in which a significant cost of doing business is removed. All things being equal (with one extremely important exception), the savings would be passed on in the market place in numerous ways.

At the same time that exempting property improvements makes perfect sense, so does a reliance on the annual rental value of land parcels for public revenue make perfect sense. This is the "exception" alluded to above. Every parcel of land has an annual rental value determined not by how the individual parcel is used but by its size and location within the community. These values are, as we see everywhere, greatest where population gathers in large numbers and where commerce is dynamic. Commerce is dynamic and profitable, in turn, where population is well-educated, highly skilled and well-compensated. In most cities today the effective rate of taxation on land parcels yields but a small portion of the full annual rental value. The untaxed amount is, in effect, imputed income to the landowner, capitalized by the interplay between supply and demand into a selling price for land deeds. Economic theory tells us that taxing away annual rental value leaves nothing to be capitalized, so that land prices will fall - and will tend to fall to low levels and remain there so long as the community increases the charge consistent with increases in annual rental value.

A real estate lender has a legitimate short term concern that shifting the tax base from property improvements and land parcels, to land parcels alone, will cause a fall in the value of collateral securing the financing provided to developers, homeowners and other borrowers. The degree of risk will be dependent upon the extent of financing associated with the acquisition of land. At the same time, the exemption of property improvements from taxation in a development where the improvement is at or close to "highest and best use" will undoubtedly result in a net reduction in tax obligation to the property owner. Other property owners - those who own valuable locations that are vacant or seriously under-improved - will receive tax bills reflecting significant increases. Most homeowners (around 80 percent of the total) in the cities fall into the former category because most residential properties in cities occupy very small parcels of land; and, even when located in or near downtown business districts, zoning and the difficulty of assembling parcels for commercial development means generally that taxes on these property owners will rise only moderately or not at all.

Clearly, owners of downtown skyscrapers and other high-rise buildings will tend to benefit materially by the shift to land parcels as the property tax base. What bankers should also consider is the increased level of (continued on page 12)

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consistent investment that will occur as land owners generally bring their parcels to "highest and best use" or decide based on the increased carrying costs imposed each year by taxation of their land holdings to sell out to a developer.

The prospect of a less volatile real estate market in which land prices remain stable and the supply of land for development more generally available is a condition the banks have every reason to embrace. Stable land prices translate into stable costs of doing business (improved on by new technologies and other productivity gains), attracting new businesses and residents. Thus, the impact on banks, on other lenders and on real estate investors is overwhelmingly positive. In fact, the impact on the bottom line is potentially so positive that I am perplexed that the financial services sector has not taken a leading role in the effort to exempt all property improvements from taxation in favor of taxing the annual rental value of land parcels.

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