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Issues and Interpretations

Editorial Note: Financing our schools has become a major crisis in the United States. Serious questions are being raised as to the role of the property tax in this financing.
C. Lowell Harriss, Professor of Economics at Columbia University, and Economic Consultant, Tax Foundation, Inc., discusses the challenges we face from rising education needs and the strains on property taxation. (The views expressed are the author's, and not necessarily those of any organization with which he is associated.)

BANKERS AND OTHER community leaders confront problems which must often seem outside the "proper" responsibilities of the job. Although almost fashionable criticisms of "business" reflect distrust and hostility (and gross misunderstanding), insistent and growing demands upon business press it to do more on many fronts. Its leaders—and its dollar contributions—are called upon to help "solve" society's problems, beyond those of production and distribution.

In many communities, for example, leaders face a 1972 version of a long-standing problem, financing education; many also face a newer one, perhaps at the doorstep—revitalizing the central city. Moreover, "reform" of property taxation may be of concern in itself. Even if not, its obvious role in paying for schools, and its perhaps less obvious tie to the growth and decline of the city, justify (compel!) more attention than merely writing a bigger check each year.

The problems range widely, reflecting the great diversity of American life. Just as the conditions of local government differ tremendously, so do opportunities. Those bankers who support a financial system of independent banks emphasize the merits of local control. The same conclusions, to perhaps even greater extent, apply to government. Travels over much of the world have yielded deep impressions of local government. We can be thankful for local authority, responsibility, and opportunity—as distinguished from centralization.

Spearheads for progress appear and press ahead. Not in every locality, by any means. But some, several, then many, localities can develop new things and then follow what seems successful. Actions can adapt to the widely diverse conditions of climate and topography, age and tradition, aspirations and hopes. Failures appear, of course, but not on a scale possible on a national level. And are they not more quickly seen and more easily reversed than if a whole country's policies must be altered?

Without romanticizing local government or blindly condemning greater reliance upon decisions from state capitols and Washington, I believe that we should strengthen the financing of local government—and in ways which will support rather than weaken the economic base. Choices which must be made (if only by default) now, will affect, for good or ill, the long-run prospects for business in the area. Issues of school finance may precipitate actions of great significance.

PAYING FOR EDUCATION: COURT DECISIONS

Worry about paying for education was not new when our grandfathers struggled with the problem. Although our grandchildren will have higher real incomes than we do, they will have trouble getting enough to pay for the schools they want for their children. Aspirations, especially for higher teacher salaries, cannot be expected to stabilize.

Ours will remain more a world of scarcity than of affluence. Can we keep expectations within limits appropriate to resources? We do have economic capacity to devote more to schools if, and this "if" is crucial, we can agree on the other things to curtail—outlays for health, food, housing, policing, transportation, improvement of the environment, art, recreation, retirement incomes, and so on.

Although such statements ought to be so obvious that one need not express them, community leaders know how generally public discussion prefers to ignore unpleasant realities.

The economist, and the banker or other businessmen, who insists that attention be given to the need for choosing among alternatives, may be dismissed as a hardhearted opponent of things obviously good. The lurking hope for Santa Claus, or Robin Hood, the search for ways to make the "other fellow" pay, pervades too much public discussion. It fosters irresponsibility. "State assumption of the costs of education" or "Federal revenue sharing" *can* change the kinds of taxes used and the distribution of total burdens among kinds of taxpayers. But there is one thing neither will do—reduce taxes.

An August 1971 decision by the Supreme Court of California compelled new examination of the financing of California public schools. Suits trying to establish the same principle have been filed in state after state. While the full significance of what the California court started remains far from clear, a December decision by a Federal District Court (Texas) accelerated the process of reexamination. The traditional degree of reliance upon property taxation to pay for education seems to have been struck a heavy blow. The judges have said that the distribution of taxable property differs so greatly from one school district to another that the differences in funds for schools deprive some children of their rights under the equal protection clause of the Fourteenth Amendment of the U.S. Constitution.

Only time will tell what the results will be. Appeals can be expected, and the judicial process can stretch out. Meantime, state legislatures and Congress will be pressed to take account of what seems to be the spirit of these decisions. (Yet neither Uncle Sam nor the typical state legislature has uncommitted dollars to pour into larger financing of schools.)

Two aspects need to be distinguished. The first is the place of "equality" as a guide of educational policy. The second involves the role of property taxation.

EQUAL OR BETTER?

Much current discussion of education runs in terms of equality. This concern flows naturally from the words of the Fourteenth Amendment. The word "equity" also appears; but it, along with its companions, "justice" and "fairness," is hardly the same. In any case, however, is there not a more important goal? Leaders should press for *better* education—*for all.* More quantity and higher quality—for all—seem to me a more laudable objective.

Equality as a goal runs the risk of moving many down toward the middle. Yet today even the best schooling, I submit, is not so good as we ought to seek. Half the schools are above the median—by definition. Who in urging *equality* really wants to lower the best? As far as I know, neither the briefs submitted nor the judicial decisions explicitly discuss the possibility of forcing down school quality in some communities. The focus, I should think, would be to raise the lowest *and* the best—improving both. Of course, some advocates will be willing to sacrifice the better quality, especially if they believe that doing so will surely raise the poorest. But would such be fair, equitable, wise, and just?

Would it be politically feasible to "cut down" where school spending is highest? Those voters who now feel that they are paying for above-average schools in their communities may not support equalizing programs.

Improving education *is* consistent with moving toward equality—by emphasis on raising the least good. How? Dollars alone will not educate. The increases provided for schools by one school district after another may, or may not, be giving results as good as can reasonably be expected. Although present dollars could probably be made to yield better value, there is widespread belief that if many districts spent more on schools, the general public over a broad area would benefit from better quality and quantity of education. Who will provide these additional dollars?

Not fully the residents of the areas which now spend too little! Presumably, outsiders are expected to pay much of any increase. But as voters such outsiders do exert influence in deciding how much tax burden they will bear. Why will they vote more taxes for themselves? How far can courts force them to do so? Is there greater willingness to pay state than local taxes for schools? Perhaps so, but the picture is less than clear.

One purpose for which many Americans will make sacrifices, for which they will subject themselves to heavy taxes, is to pay for schools for their children. Will voters do as much to finance more education if there is less of a tie to their own children? Some may, some may not.

As voters are pressed for tax dollars now, some may be reluctant to shoulder heavier burdens to pay state or national taxes for schools elsewhere. Over the years, I suspect, a significant local identification (1) of prospective benefits (2) with payment obligations, can have positive results as regards taxes designed to finance better *quality.*

What value system leads people to sacrifice for the welfare of children? As long as scarcity bears upon Americans as it must, even those with the best of good intentions are compelled to curb the desire to be generous.

A "foundation" level of school spending guaranteed by state finances will elicit strong support. But it will not do as much as some people wish and are able to pay for. If free to do so, some communities will exceed the general average. The country will benefit from this local freedom. The results of better schooling do extend beyond the area that pays the excess. People move. Positive "spillovers" are no less real than the negative ones which are cited convincingly as a reason for taxing over a wide area to pay for a (rising) level of schooling for all.

Many an American in the upper middle income group is troubled by present taxes. He or she can pay still more. In many cases, more or less willingly, Americans will reduce personal consumption and saving to pay more to government. They are more likely to do so, I suggest, the more they expect their children to benefit.

Some groups supporting the court cases argue that if people in community A want to pay, say, $2 more for the education of their own children they will also have to pay $2 more for children in other parts of the state. Does this seem fair? How would it affect incentives? Is one too unrealistic and old-fashioned to believe that effort and thrift make a difference and are not unaffected by the prospects of rewards? What would be unfortunate is a condition in which the people who can pay for better education, who must be willing to support heavier taxes, will oppose because too much of additional amounts seem likely to go to "others."

For the best results in financing education, a local element may need to be larger than seems consistent with the new court decisions. In any case, preserving and improving what is now "better," as contrasted with "equalizing," presents challenges to local leadership.

PROPERTY TAXATION: MORE PROGRESS, LESS POVERTY, GREATER EQUITY

The largest state-local revenue producer deserves increasing attention from community leaders. All who are seriously concerned with the health of cities should look at property tax reform as a strategic lever for improving the economic framework. Property taxation will be with us, as a major element of the economy, for as long as we can see. It not only raises almost $40 billion a year in revenue but influences the nature of local growth, or decline. In spite of complaints and "demands" for relief, none of the alternatives—(1) spending reduction, (2) higher income or consumption taxes (at local, state, or national level), or (3) greater government use of service charges—seems likely to permit more than minor, incidental, and temporary cuts in property taxation.

It has faults galore. As it exists in practice, in one place or another, it can be justly criticized by every criterion relevant for judging a tax. Yet property taxation can be made into what by most, or all criteria, is a good tax—in one respect the best.

Total yield rises rapidly, faster than one would expect from the complaints about its unresponsiveness and lack of upward revenue potential. But gross inequities exist because of poor assessment (and other reasons). High rates on buildings impair economic progress. Low rates on land discourage best use. Only a minor portion of land value increases actually get into public treasuries, rises which result from general economic change, not from the owner's actions. Such increases seem a most desirable basis for financing (local) government.

The opportunities for improvement are huge. Although some desirable changes require action by state government, and although Congress might exert pressure, localities can do much—on their own, in response to local leadership.

Some elements of reform seem clear. Much agreement about defects and their remedy will be found, some disagreement—and a lot of opposition. (Sometimes I feel that most Americans, at heart, hope to benefit from land speculation.) Feasible changes would materially improve our communities, our businesses, our homes, the whole economy—while distributing the costs of government more equitably.

Better Administration

One need must be obvious—improve administration. Almost any adjective of opprobium would properly apply to property tax administration in more than one community. But the defects can be reduced. They should be. The methods have been formulated. Many have been tried, and tried with success. A banker need only compare tax assessments with appraisals he would accept for loan purposes to see the challenge. An unconscionable amount of poor assessment is tolerated.

Civic organizations, business and professional associations, and other groups seeking to advance the public interest, should give active—and sustained—support to the reform of property tax administration. Professionally competent assessors can be made responsible and supported. Large inequities, long lags, inappropriate valuation criteria, ineffective appeals processes, favoritism and corruption, incomplete recording, and inconvenient payment requirements, these are not necessary. Every community on its own can make progress. And state governments are more likely to proceed in stimulating assessment improvement—and other phases of property tax reform—when support comes from a base of intelligent leadership.

Hardship Relief

Another type of property tax improvement is removal of "equity stingers." Some states have already shown how to grant relief to older persons in need, and to others of low income, without undue revenue loss.

Unfortunately, however, most communities face an unpleasant reality: To pay for the volume of government which voters seem to approve, the tax net must spread broadly and catch small as well as large "victims." The Santa Claus dream is not a harmless indulgence of "political oratory" when it fosters a belief that the mass of homeowners (and renters) can get more dollars for schools and other governmental services without shouldering heavier taxes.

Rational Recognition of Economic Reality: Site Values as the Base for More Revenue, Buildings for Less

A more fundamental reform would build upon a basic economic principle. In an inherent economic sense "the" property tax is two widely different levies. One rests upon land as the product of nature and society. The second is the tax on buildings, machinery, and other manmade property.

A change which can be achieved would alter the incentive system so that men would then modify their private behavior in ways more conducive to community well-being. Moreover, in my view, local government revenues would be raised more equitably.

The basic idea is old—but largely untried. Mention of Henry George and his single tax proposal may evoke mixed responses. Without pretending to support the "single" aspect, the underlying principle has great merit. Reduce tax rates on buildings and machinery, substantially, and boost the rates on land values. A transition of five years, or more, could permit gradualness without delaying the major benefits unduly.

A tax on buildings (and on machinery and inventories of business) can have undesirable results. The quality and quantity of improvements suffer. The tax on land, however, can be one of the best to get funds for local government. Over the years, in fact, the tax on land value can be the most nearly painless way to raise substantial revenues—and to raise them equitably by absorbing a fraction of what is called "unearned increment." The land tax can also exert *desirable* nonrevenue results to improve land use.

Cost of Space and Land Prices

The quality of life for tens of millions suffers because funds are not adequate for the facilities which governments are expected to provide. Yet, people pay "heavily" for living and working space. Their demand pulls up land prices. Bankers and builders will be aware of the high and often rising land component in the cost of housing.

Yet the increasing amounts paid for the use of land go primarily to private owners but *not* for the production of land. They get increments of value which they do not, really, earn. The issue is *not* whether the user must pay. The issue *is* how much will go to government, how much to an owner of land at purchase or by annual rental.

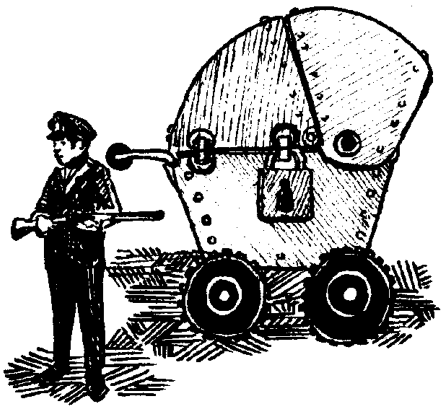
Population growth and rising income multiply the need for governmental services. They also create a potential source of funds for meeting some of the costs (1) without making the user of land as much the worse off, and (2) without endangering the supply of land. Such?

LAND—LOCATION—AS A PRODUCT OF NATURE AND OF SOCIETY

Land as a productive resource resembles labor and capital in some respects but differs in others. The similarities include the fact that parcels of land, especially the desirability of location, vary greatly as do human skills and machines. An outstanding difference is the way they come into existence. Labor and capital are manmade. The quantity and quality of training, the vigor of human endeavor, the amount of machinery and structures, all these depend in part upon (1) what individuals expect to get in compensation, and (2) the payments they actually do receive. To obtain such productive capacity, society must pay. Moreover, attempts of society to take back through taxes what customers have paid for the services of capital and labor will affect the future supply.

Not so with land. Nature created it in the physical sense—and society has created much of the demand which makes some locations highly desirable. The amount of land in existence will depend scarcely at all upon the dollars paid to use it. The payment, however, does make a difference in (1) what becomes available for active use within any few years, and (2) the particular use to be made of a parcel, its allocation among alternatives.

Because parcels of land do differ immensely, something to help allocate use efficiently is of utmost importance. Payments for the use of land do perform a function of outstanding significance—allocation. But payments do not, as for manmade productive capacity, also perform the function of inducing the creation of the production resources; except—and this fact is real: Costs borne by private developers (streets, drainage, etc.), and even more so the costs incurred by the community, do affect the desirability of locations.



Around large American cities, from $15,000 to $20,000 of governmental spending on streets, schools water and sewage, and other facilities will often be needed for each new dwelling. As such facilities are built, as population and incomes rise, land prices go up. The National (Douglas) Commission on Urban Problems estimated that in the 10 years to 1966 (and despite rising tax and interest rates), land prices rose by over $5,000 per family. Even a modest fraction of that $250,000 million if used for financing local government would have permitted a welcome reduction of the tax burden on buildings.

The quantity of land—space—in an area is fixed. Land cannot move. Here is the community's one resource which competitive inducements will not entice elsewhere. Tax it heavily, and it will not move to some other place, or decide to take a vacation, or leave the inventory of productive resources by going out of existence. Tax land lightly, and the favorable tax situation will not create more surface area. Rarely will the amount of space be subject to more than a little change by actions under the control of man.

The value of location, however, does depend in part upon what is done, especially by society, to make the area attractive. A tax on land will not reduce the supply of space. A tax can capture, to pay some of the costs of local government, much of the value of what the public itself has created.

Private Ownership of Land

Does the ethos which ties equity (economic justice) to rewards which are based on accomplishment lead to justification for rewards because of the ownership of land? Differences in payments for human services or for the use of capital can rest upon what the recipient has done; his accomplishments as valued by consumers in the market do provide a rationale for what he can get. In general, however, the owner of land has difficulty showing any comparable contribution.

The "moral" justification for reward based on creativity gets transparently thin when related to what can often be obtained as an owner of land, especially increments. The owner's contribution to production may have been nil. Or it may have been positive in getting land into better use. Some owners, however, keep land in a use below the true potential worth to the community. Land can be—and is—held in a form of low productivity waiting for community progress to raise its price.

Social Costs of Sprawl

Urban sprawl is familiar. Failures to make use of land would be more evident if we made more effort to stop and look. Think of the costs in extending streets and utilities farther out—and the years of life in extra travel time—as compared with more compact development.

Extensive but scattered underuse are most likely to result when owners are free from great pressure to search out the best opportunity and then to exploit it. One reason for failure to do what would seem to be in his own interest is "low" out-ofpocket cost (after income tax deductibility). Waiting for general advance of demand in the locality to bring him capital gain may be sensible for the owner even though the community incurs a largely unrecognized cost in less than the best use of land. Private ownership does not yield the benefits which are ordinarily cited as conforming with total welfare.

Underassessment of Idle and Underutilized Land

The tax on vacant and underutilized land may now be less than if the land were valued "correctly." Current money income will be low compared with what it would be from the best use possible. If the assessors value by capitalizing current income, then the property will be undervalued. The current figure may fall far below the possible income—what an owner could receive.

Often a significant part of what the owner expects to get—and eventually does receive—is a rise in price. Land used as a parking lot or obsolete housing or commercial use may bring only a modest amount above net operating expenses. Over a few years, however, the price of the land may go up by half, doubling, tripling, or even more. The relevant annual "income" should include the growth in value. Unfortunately, the increments from year to year may not be determinable with anything approaching precision. Yet to ignore them is to distort—and to undertax—to a most undesirable extent.

PROPERTY TAX EFFECTS ON STRUCTURES

The supply of buildings presents a striking contrast to land. Heavy taxes on buildings will reduce the quantity and quality. These taxes help to account for some of the deplorable features of our cities. There is merit in reducing the tax rate on structures.

Per unit of floor space or cubic contents the property tax on buildings hits well-constructed, high-quality, structures far more heavily than it does slums and "junk." The tax structures creates an incentive against upgrading of quality, especially in those parts of older cities with urgent needs but also with high tax rates.

Would not wise public policy encourage, not discourage better structures? The present tax discriminates in favor of buildings which produce bad neighborhood effects. The owner of a dilapidated structure will be freer from economic pressure to replace it with something better if his assessment goes down because the building gets worse. Any individual or business wishing to shift to use of a higher quality structure must also pay more, often much more, toward the costs of government—and not for more (or higher quality) services.

Cities that urgently need to replace obsolete and decayed buildings rely heavily on a tax which creates a [substantial] bias against replacement.

The quality of building space available for work and living will depend greatly upon the maintenance of the stock of older buildings. Undermaintenance forms one way by which an owner can reduce his net investment in a building and the annual tax. His actions in letting a building run down will hurt others, the larger neighborhood. Good maintenance, however, can be combined with improvements which have "spill over" benefits for a broader neighborhood.

Property taxation has some influence—adverse—on maintenance. The tax reduces the net return and thus the attractiveness of putting more dollars into such properties. With or without good reason, the owner may fear that a "repair and maintenance" job having visible results will bring an assessment increase.

Effect on Price: Building and Land

The property tax on buildings adds to the cost of supplying them and to the price which must be charged. Analysts of the shifting and incidence of property taxation have not yet come to agreement on the extent to which the portion falling on buildings eventually rests upon suppliers of capital as against consumers using the buildings or the things they help to produce.

Unquestionably, however, in some localities this tax makes for higher cost of housing. In using the building, whether for business or private residential purposes, a substantial cost-of-government element must be included. In this way the tax will reduce the amount demanded. One result is a hidden, or what economists call an "excess," burden. For example, within considerable limits, the cost per cubic foot of construction declines as the size of the house, apartment, office, or other unit increases. The tax on structures creates pressure for building smaller rooms, etc., with less of what we really want in living room and amenities per unit of labor and materials used in construction. By indirectly altering the type of construction, the tax on buildings thus deprives the occupant of potential benefits for which government treasuries get no dollars.

The tax on land, however, makes for a lower price (beyond the effects of inducing owners to reduce speculative withholding and putting more on the market). If tax on land is increased, the amount remaining for the owner drops. The price a buyer will pay goes down. Government takes more. The user pays no less for each year's use, but government through taxes preempts more.

In this way property taxes on land are "capitalized." They reduce the price which a buyer will pay. Thereafter, the user (buyer) of the land turns over, in effect, more of the yield to government. But the person who has purchased after the tax became effective does not suffer from it. The owner of land at the time "paid" the tax increase in perpetuity. In practice, what he fails to get may be only a portion of a price rise due to social change.

Other Effects of High Taxes on Improvements

High tax rates on buildings (and little reliance on land value) reenforce incentives for creating "islands" of relatively low tax rates. One defect of property taxation for school finance which the court decisions have noted is the inequality of tax base per child. A large industrial or utility or commercial establishment may serve a public residing in a far more extensive area. The tax, we can assume, is borne largely by consumers or investors in the broader area. A few localities in a metropolitan area will have tax resources which are above average in relation to service obligations. With lower tax rates they can have above average quality of services, attracting still more investment. This result comes predominantly from the inequality of tax base in buildings, not land.

Some communities use zoning power to exclude types of property associated with high governmental expense—the high-density housing which requires heavy school costs. Other parts of the metropolitan area, however, must pay higher taxes; elements of a vicious circle gain strength.

People who wish to escape the urban center must leapfrog over the "islands." Such land use imposes higher costs than if population were spread more in accord with factors free from the influence of tax on buildings. Some disadvantages were noted earlier in discussing "sprawl."

A Note on Distribution of Burden and (Alleged) Regressivity

Who actually bears the burden of property taxation? Neither the theoretical analysis nor the empirical evidence is as clear as we should like. A part of the tax on commercial, utility, industrial, and housing structures can be assumed to fall on consumers more or less in proportion to spending. This part, then, has some of the regressive element which is often cited in condemning the tax. But despite frequent implied assertions to the contrary, a part probably remains on suppliers of capital; this will be more progressive than proportional (and not regressive). The considerable portion which falls on land, much of which was capitalized in the past, is hard to place in a meaningful sense—except to say that past and present landowners are generally "not poor." The distribution of this burden will be decidedly more progressive than regressive.

In short, although families with "low" incomes or consumption do bear property tax, persons who own, directly and indirectly, "large" amounts of property must carry burdens which are "heavy." Any reduction in tax rates would confer windfalls according to ownership—and property ownership is more concentrated than that of income.

Pressure to reexamine the financing of education should not, in my judgment, lead to abandonment of a large enough local element to permit meaningful efforts by communities which are able and willing to exceed the average. Property taxation can provide an instrument for doing so. It can also provide a source of funds for states which decide to pay for a bigger portion of school costs.

In any case, however, reform of property taxation should have a high place on the agenda for public action.

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