TAXATION, 1970

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Marvels of Rotary first came to my attention when as a young boy I attended the annual Rotary picnic for the youth in a small Nebraska city. All the hot dogs we could eat, lemonade from a bottomless source, then icecream without limit -- all such generosity created an impression which I shall never forget. Since then, although not a member, I have had some awareness of your activity in many cities of the world. How much better off mankind would be if there were more such organizations, operating on a more extensive scale!

Man does have it in his power to make his world better -- or worse. Not the least influential of manmade institutions has become the tax system. Heavy now, it may well be the biggest legacy some of us will leave our children.

Today, I would like to talk about two quite different aspects of American taxation and opportunities for reform. The first involves the national government. In the sense of our ability to exert meaningful influence this determinant of our life may seem remote, remote indeed in relation to our "contributions." But changes can be made, for better or worse. The second topic involves heavy taxes much closer to home, those on land and buildings.

BUSINESS TAXATION

The Federal tax of roughly 50 percent on corporation earnings exerts a needlessly bad influence on production. The results are wider, deeper, and more deleterious, I submit, than is generally recognized.

The Role of Business

Supporters of taxes on business net income seem to expect them to "burden the company" -- whatever that may mean.

Business are the organizations upon which Americans rely for most of what is produced. Although valuable results come from the efforts of teachers, judges, military personnel, and other employees of government -- as well as from the efforts of those who work for private universities, hospitals, and other organizations not seeking profit -- most real income consists of what people accomplish through business firms.

Business is the public's major agency for organizing labor and capital to produce -- and to produce more, rather than less, efficiently. Businesses are groups of people seeking to benefit themselves by serving others. It is this service, whether in producing and distributing things or in rendering services directly, which the public wants. The process of meeting the desires of consumers can be more or less efficient in terms of inputs per unit of output. A market economy relies primarily upon competition in markets to induce efficiency -- and to stimulate growth. For it is in business organizations that we find not only the source of more of the old, but also most aid to rising living stardards.

The public interest calls for each business: (1) To turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market, or through government agencies. Part of this task of business is to anticipate, identifying wants which can be satisfied by new types of goods and services. (2) To produce by methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

The total accomplishment of people working as business organizations will depend upon many things: the training, inherent ability, and acquired skill of workers; their willingness to exert effort; the amount of capital -- (1) in the physical sense of buildings, equipment, and inventory, and also (2) in the financial sense of money, without which transactions as we know them would rarely be possible; the degree of competition; present and expected demand; the state of technology and speed of scientific advance; the competence of management; and other things. Among the "other things" are some for which government is responsible -- the system of law and order is one, and the tax structure another.

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Taxes are obstacles in the sense that they take from the taxpayer without directly giving him an equivalent. Do taxes on business earnings help the community to get the output most desired? Such taxes do not improve the process by which consumers indicate the relative importance of their many desires. Nor do taxes on business income help managers learn about the relative scarcities and productivities of inputs. But taxes do affect the alternatives which a business manager must consider, the incentives open to him when acting for the company. One incentive is to reduce taxes. In adopting methods which cut the tax bill, however, a business does not economize on the "input" of government or reduce in any perceptible way government's use of resources. Nor in selecting a tax-saving alternative does the firm increase its operating efficiency in the sense of using fewer real inputs per unit of output.

A business, in fact, may wisely adopt methods which are "second-best" as regards the use of resources. The tax factor makes some methods financially the best when in a more real sense they are inferior. Taxes thus give rise to an element of conflict between private and public interest. They induce the manager to redirect the firm's activities, away from what is fundamentally most efficient. Taxes lead to results which are less than optimal when judged on the basis of economic productivity and the allocation of resources.

The recent pressures to reform income taxation have made much of the folly of tolerating avoidable distortions in the allocation of resources. Productive capacity is not allocated to the uses, and in the proportions, which are fundamentally best. Too much investment goes into forms with less burdensome tax consequences; too little then goes where taxes will be high. The economy loses some real income. The loss is a burden -- but one which is largely concealed, which cannot be measured. As corporation income tax rates have gone up and up, the effects of distortions have certainly increased.

Reasons Advanced for Taxing Business Income

How can we account for the heavy taxation of business? Accident and temporizing to meet emergencies -- notably war -- have played a larger role, I believe, than has the rational evaluation of alternatives.

From time to time "business," especially big business, has drawn sharp criticism from writers and "reformers." Whatever the bases for such criticisms, school books, fiction, writings of persons who probably consider themselves "intellectuals," and other molders of opinion, have perpetuated attitudes which contain no small hostility to business. There also seems to [illegible] be a deep-seated belief that "business" somehow has taxpaying capacity -- "Business" or "corporations" as distinguished from people as stockholders, consumers, or employees. The big corporation, seemingly impersonal, appears as an inviting target for the tax collector. Moreover, on the assumption that the shareholder bears the burden, and recognizing that shareholders -- especiall the owners of large numbers of shares -- are the more prosperous members of society, advocates of corporate taxation defend it as progressive.

Any resulting progression, however, is crude at best. It is not the type which can be defended as leading to either vertical or horizontal equity. Furthermore, in the United States it is not true that a corporation income tax resting on shareholders imposes no burdens on low income groups. Some shares are held by people with "low" incomes. Large amounts are held by philanthropic, educational, medical, and other organizations whose activities serve even the very poor. Moreover, pension funds for employees of businesses, nonprofit organizations, and some state and local governments own substantial amounts of corporation stock.

High U.S. corporation tax rates went into effect during time of war and postwar boom when employees, owners, and government could all increase their "take." Concurrently, the rise in rates of tax on personal income, it was argued, justified substantial increases in the rates on corporations. As the years have passed, justification has alos been found in the argument that burdens have been capitalized in the prices of shares and in a sense constitute no burden on present stockholders, especially those who have bought since current tax rates went into effect.

In the formative years of income taxation in the United States, some economists introduced another argument. Pure economic profit, they said, is a true surplus. To tax it is not to burden the reward paid for an essential cost of production. That concept of pure profit, however, is not the income concept used for tax purposes. Lawmakers have defined "taxable income" in terms very much broader than the notion of pure profit as a true economic surplus.

<u>The Corporation as a Vehicle for Postponing or Escaping Personal Tax</u>

Up to this point I have found little or no merit in reasons put forth for high taxes on corporation income. But other considerations remain. To some extent corporations <u>are</u> separate from their owners -- and in ways which <u>can</u> have tax significance. Two different aspects demand mention: (1) the equality of tax burdens on incorporated and unincorporated activity, and (2) the possibility of tax avoidance, about which a few words must be said.

Not all corporation profit is paid out in dividends. The part kept in the business is not subject to personal income tax. The owners are not so well off, presumably, as if they had received the income in cash, free of tax; but at least the persons in control must expect those whom they serve to be better off than if they had received the earnings in cash and paid the personal income tax. The growth of assets (or decline in liabilities) resulting from the plowing back of earnings enhances the ownership interest in the business. What would have been dividends are presumably coverted into capital gains. Any such possibility obviously has tax significance, but not in any simple relation to other considerations. The existence of the corporation does make a difference in taxes on the owners because of the retention of profit.

For logical solution to the problem of taxing retained earnings, however, one will hardly look to our present tax, one which falls on all corporation earnings. Whatever is paid out to shareholders does get into their taxable income.

Uncertainty about "Why Really Pays"

Some who give serious thought to the shifting of the Federal tax on corporation income as among consumers, stockholders, employees, or others, will confess to great uncertainty. Others feel considerable assurance. I fall between, confessing to much doubt but also enough confidence about the final resting place of taxes on corporation net income to proceed to make judgments about policy.

One problem is to distinguish between shifting in the short run of a year or two and over the longer run. Changes in tax on business earnings whether resulting from fluctuations in pre-tax earnings, from a change in the tax rate (48% to 52.8%), from the definition of the tax base (depreciation deductions), from the tax structure (investment credit or treatment of multiple corporations), or -- in regard to regulated public utilities -- the decisions of regulatory authorities, will be reflected for a while in what remains for stockholders. As time passes, however, adjustments take place. Let us look at part of the process, a part of great significance yet sufficiently out of sight to be generally ignored.

A business must have equity capital. Supplying it costs something. The stockholder sacrifices the opportunity to use his wealth in some other way -- lending or buying power. Such sacrifice is an economic cost. Although income tax law and traditional accounting do not recognize this cost as a deductible expense of doing business, consumers will not get equity capital to work for them -- and employees will not get equity capital to work with -- unless the people who can provide ownership capital expect to receive total net benefits which will equal those obtainable elsewhere.

In other words, suppliers of capital, whether in debt or equity (ownership) form, expect to be rewarded. What counts are the rewards after tax, especially when taxes differ appreciably. A "normal" after-tax return on equity capital is an essential economic cost. The net after-tax yield which a supplier of equity capital will insist upon, in expectation, will be as high a yield (conceived broadly as a total net benefit, including growth in value perhaps as a share in economic growth) as he could obtain from any alternative use of his funds.

The equity capital already in a business, of course, is largely sunk, except as depreciation permits gradual withdrawal. For a time, at least, it must remain regardless of actual earnings. Expansion calls for new capital, and in the modern world mere survival often requires growth. To get new capital, the business must offer attractions which are equal to those otherwise available to the suppliers of funds. Where can the company, in turn, get funds to compensate the persons supplying capital? It must look to customers for dollars. If the corporation income tax rate is 50%, and if potential suppliers of new equity capital insist upon an expected return over the years of 10%, then the corporation must expect to get a price from customers which will yield 20% before tax. Except some retained earnings, only those new projects which offer a firm prospect of a 20% gross return, will get equity financing in competitive markets.

The corporation will not succeed in selling new stock unless the prices which it expects from its customers will bring an adequate after-tax yield. The expansion of output (in a growing economy) will lag until prices are high enough to give profits which after tax do satisfy investors. Supply in relation to demand adjusts to affect product prices. Over the long run, then, some or much of the corporation income tax will be paid by consumers. The indirectness of the process conceals most of it; but the result does include a tax on consumption with some falling on shareholders whose expectations have been disappointed perceptibly. The tax falls capriciously, unevenly, and not in line with any concept of fairness familiar to me. Corporations producing products for which the demand is not growing and which do not seek new capital, may never be able to shift an increase in a tax rate.

Will a reduction in tax on corporation earnings be followed by price reductions? Not perceptibly within the month, even if commissions regulating public utilities are exceptionally alert. But competition works. Gradually, rather than quickly, supply will rise and prices will reflect the decline in cost of equity capital. The amount of advance notice will make a difference.

The actual shifting of tax increase or reduction to the consumer will depend to some extent upon what happens to the total supply of, and total demand for, capital. The amount of capital available for new investment in business is not fixed. The amount available for equity investment in corporations is certainly not fixed.

Let us assume that the tax on corporation earnings rises to make the prospective yield on corporation earnings less than otherwise and less after tax than available in some alternative uses. The potential supply of equity capital for corporations (out of a given total of funds for investment) will decline; more of the total of new savings will seek investment in debt form. The rate of return on debt will then fall. Thus, a rise in the tax on corporation income will tend to reduce not only the after-tax yield on equity capital (until shifting to consumers gets under way) but also the yield for suppliers of debt capital. The corporation tax thus becomes a more generalized burden on the suppliers of capital. The magnitude and the distribution of this burden cannot be measured nor compared with the amount passed on to consumers. Nor do we know how the amount of saving and the type of capital formation are affected.

If we seek to put more of the cost of government on people in their capacity as suppliers of capital rather than as consumers or recipients of earnings from labor, what are the reasons and the results? The role of capital is central to economic progress. Extra taxes burdening those who supply it cannot help, and may seriously hamper, the achievement of important objectives.

Any process of shifting operates in an environment in which conditions constantly change. Lags and frictions will inevitably slow the process. No single set of forces has an opportunity to work itself out completely and fully. Profit results depend on all the many factors of cost and selling prices which affect a company. The reasons why some corporations are more successful than others in getting a satisfactory after-tax return differ widely. In a dynamic economy flows of new equity capital depend upon many factors, including some which are neither rational nor farsighted. Businesses competing with others which are free from tax -- perhaps those operated by government -- must expect considerable difficulty in passing the tax to consumers through the market process. Other factors are foreign competition, the extent of production from firms with large proportions of debt finance, and "special features" of the tax law (or its administration) such as deductions for depreciation, depletion, and reserves for losses.

As a tax on consumption the levy on corporation income is haphazard and capricious. As a burden on suppliers of capital it has effects which are certainly not clear. One conclusion, however, seems clear to me: A major tax whose exonomic effects are so difficult to identify and measure -- but some of which wise men must shun rather than seek -- can hardly be the best that man can devise.

Significance of Definitions of the Tax Base and the Taxable Unit

"Income" or "profit" or "earnings" may seem to be reasonably clear as concepts -- unitl one tries to define them for purposes of taxation. The same applies when trying to prescribe just what is the business unit to be taxed as a single entity (e.g., each corporation having a legal identity or a group of related corporations), to say nothing of corporate reorganizations and family partnerships.

If tax rates are low, and if differences in tax rates are small, the results of one, as contrasted with another, provision or interpretation may be inconsequential. Today, however, considerable tax may sometimes depend upon apparently minor details of definition. Companies must be careful to meet the requirements of law. Economic distortions and resource misallocations result from adaptation of business affairs to meet the provisions of tax law. Some aspects of tax law become major determinants of business actions -- the treatment of depreciation, for example. Corporation mergers of recent years have been influenced, to say the least, by tax considerations; the conversion of equity into debt capital with equity aspects but qualifying for deduction of interest has permitted rather amazing financial results.

The whole economy may be affected somewhat by seeming technicalities of tax law. Unfortunately, the results may appear slowly -- but not always "appear" in the sense of becoming full evident. There may be quite a long "recognition lag" by businesses and, more often, by the public. Correction may take still longer -- witness the decades taken to "correct" the arbitrary shortening of depreciation lives in 1934.

Inequality of taxation can result from apparent technicalities of definition. The amount of tax borne by different taxpayers will not be in line with the realities of their economic positions. Perhaps the differences are those intended by the lawmaker, perhaps not; perhaps generally desirable, perhaps not. Often, no one can be sure of the results because of another consequence -- complexity.

What to Do?

The Tax Reform Act of 1969 including repeal of the 7% investment tax credit, boosts the taxes on business by $6 billion a year. No quick "correction" is possible. What can be done? Neither relief at the stockholder level by reinstatement of the dividend credit of 4%, nor return of the investment credit seems probable. For the near future the pressure for revenue -- growing out of apparently insatiable demands for increases in expenditures, nondefense spending -- will not permit the reduction in tax rates which would be best for justice and progress.

The "goal" I propose: Reduction of the 48% rate by 1½ or 2 percentage points a year to a level of 20% or so. Growth of the economy would usually make up the effect of rate reduction to maintain revenue. This program would take time. If not much relief can expected soon, a start can be made.

The best prospect for action this year seems to me to be some reform of depreciation. This is a technical subject, one about which the layman's competence must be limited. Even specialists may disagree.

One source of disagreement is whether present practices do in fact represent reasonable adjustment of write-offs for tax purposes. Is there "proper" recovery of capital?

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An issue which should be pressing grows out of the failure of our tax laws to adjust depreciation for inflation. In a period of two years or so of "moderate" inflation, the tax-generated erosion of capital will not seem huge. Nevertheless, inflation has been worse than moderate. Unquestionably, the failure to take account of replacement cost under present conditions can have serious effects. The tax rate (state tax included) will be somewhat over 50 percent in most cases; not many years are required before taxing so-called profit at this rate will eat away part of the capital base. The dollars get into the government treasury and are spent -- without adequate recognition that the businesses involved cannot maintain their productive capacity in a world of inflation. It is not easy to decide how a system could best be reformed to give more recognition than does ours of the fact that productive capital facilities, depreciated on a cost basis, can rarely be replaced from depreciation reserves when the tax rate is 50 percent. **

* Subsidize business (Pennsylvania?) [illegible]

A friend of mine, well qualified to judge, used the term "supine" to describe the reaction of businessmen to the anti-business tax proposals of recent years. A term so strong may be inappropriate. Yet does not the failure of business leadership to give strong support to the Nixon Administration's 1969 proposal for a 4 percent reduction in the corporation income tax tend to confirm the dismal conclusion that concern for protecting stockholders and consumers leaves something to be desired? The Tax Reform Act of 1969 reduced substantially the tax on individuals but raised nearly as much from them through heavier burdens on corporations. This package grew out of desires to reduce taxes on individuals, a worthy impulse. Let us hope that before long, room for more net tax reduction will open up so that the anti-capital*** elements can be moderated.

* Why single out "business" for sole protection against inflation?
** Tax rate has no bearing. Nor does inflation. New investment can be depreciated - before taxes. That is all anyone in business requires.
*** - There are no anti capital elements so long as these taxes are "indirect"

GROWTH OF SPENDING

all

At both the Federal and state- local levels of government, the growth of ~~(nondefense)~~ spending presses upward. Obviously, the source of ~~much~~ more of our very real concern about taxes lies in the rise in expenditures. Lamenting the growth of government spending was not new when the old among us were young. The reasons for growth are numerous, the forces strong.

(Data will be included in the oral presentation.)

not in "defense" spending - 12%

In what cases are present expenditures yielding good results, better than if taxpayers were free to use the dollars? Which of the many proposed increases will in fact yield for the general public benefits which are as valuable as the tax dollars they require?

So why we are trying so hard to massacre the military

Determined efforts to improve decision-making on government expenditures policies deserve public support. So do efforts to improve operating efficiency. The methods open to the citizen, unfortunately, seem weak relative to the magnitude of the problems. Here, I suggest, lie some of great challenges of our society.

THE BIG TAX CLOSE TO HOME

This audience need not be told that property taxes can be very high indeed. Boston has one of the country's highest rates. This part of the country -- the Northeast -- has real opportunity for reform.

Civic leaders yearn for ways to exert constructive influence by changing the framework of the economy. They look for a change which can be achieved and which will alter the incentive system so that men will then modify their private behavior in ways more conducive to community well-being. Property tax reform offers such an opportunity. My proposals here envisage no increase in total burden.

The basic idea is old: Reduce tax rates on buildings, substantially, and boost the rates on land values. High and rising land prices could provide more funds than they yet do for much needed services of local government. (Recent travels to many cities abroad convinced me that achievements fall sadly below what ought to be attainable in drawing upon rising, often soaring, land prices to pay for government facilities.

The property tax often exceeds $200 a year per capita -- over $1,000 for a family of five. At such levels it exerts powerful effects, not merely the taking of money but also the influencing of investment and land use. The nonrevenue results are substantial.

Economically, "the" property tax is really two. One, the tax on buildings (and on machinery, inventory, and some other tangible personal property) can have the most undesirable nonrevenue effects. The quality and quantity of improvements suffers. The other element, the tax on land, however, can offer one of the best means of getting funds for local government. In fact, the tax on land value can be the most nearly painless way (over the larger run) to raise large revenues -- and to raise them equitably -- while exerting desirable nonrevenue results.

Urbanization -- Costs of Space and Land Prices

The quality of life the tens of million who live in cities suffers because funds are not adequate for the facilities which governments are expected to provide. Yet, people pay "heavily" for living and working space in the city. Their demand for room sends land prices up and up. And most of the increasing amounts which urban residents pay for the use of city land, these large amounts go primarily to private owners.

The congestion in cities which multiplies the need for governmental services also creates a potential source of funds for meeting some of the costs (1) without making the user of land as such the worse off and (2) without endangering the supply of land. Moreover, the tax which brings about this result can also exert pressure to put land to better use.

Land - Location - as a Product of Nature and of Society

Urban land as a productive resource resembles labor and capital in some respects but differs crucially 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. Labour and capital are man-made. The quantity and quality of training, the vigor of human endeavor, the amount of machinery and structures, all these depend in part upon what individuals expect to get in compensation and the payments they actually do receive. To get 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, land. Nature created it in the physical sense -- and society has created much of the demand which makes some location highly desirable. The amount of land in existence will depend scarcely at all upon the amount paid to use it. The payment, however, does make a difference in what becomes available, and the particular use to be made of a parcel, its allocation among alternative uses.

Because parcels of land, especially in their characteristics as space and location, 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 not, as for man-made productive capacity, also the function of inducing the creation of the productive resource.

Yet there is an exception; the costs borne by private developers, and even more so the costs incurred by the community, do affect the desirability of locations. Each new dwelling around New York, Los Angeles, and probably most other large American cities requires from $15,000 to $20,000 of governmental spending on streets, schools, water and sewage, and other facilities. As population grows and incomes rise, as such facilities are built, 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 the $250,000 million if used for financing local government would have permitted a welcome reduction of burden on buildings.

The outlook for population and general growth leaves no doubt in my mind that urban land prices 10, 20, and 50 years from now will, in the absence of special action, be higher than today. Probably much higher, even without general inflation.

Land cannot move. Its quantity -- space in its basic nature -- is fixed. 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 favourable tax situation will not create more space on the surface of the earth. Rarely will the amount of space or surface in an area be subject to more than a little change by actions under the control of man. The value of location does depend upon in part upon what is done, especially by society, to make the area attractive. Prices of land result to a considerable extent from investments by the general body of taxpayers. A heavy tax on land will not reduce the supply of space. Such a tax can recapture to pay some of the costs of local government, obtaining much of the annual rental value or worth of what the public itself has created.

Private Ownership of Land

Does the ethos which ties economic justice to rewards based on accomplishment lead to justification for large rewards because of ownership of land? Differences, perhaps very big ones, in payments for human services or for the use of capital can rest on what the recipient has done, his accomplishments as valued by consumers in the market. But frequently the owner of urban land, and suburban, has difficulty showing any comparable justification.

The "moral" justification for reward related to creativity gets a bit thin when related to many of the increments in land prices. The owner's contribution to production may have been nil or somewhat positive in getting land into better use from time to time. But he may have kept it in a use below the true potential worth to the community. Compared with labour and capital, land offers much greater possibilities of enhancement of private wealth without regard to the productive contribution of the person benefiting. The owner, however, does have incentive to allocate and to direct use into better rather than poorer alternatives. The scarcer the land and the greater the price it can command, then the more important for the community that it be used well. Private ownership presumably tends to bring about this result.

A drive in or around a large, or not so large, city leaves no doubt that failures to make best use of land do occur. They are most likely to result when the owner is free from great pressure to search out the best opportunity and then to exploit it. If he is ignorant of the possibilities, he will not get land into best use. Or he may be well enough supplied with income to be able to indulge his preferences for some suboptimal use. Out-of-pocket costs (after taking account of income tax deductibility), may be relatively small. Perhaps he may delay change in land use because sale of his land would bring a heavy tax on capital gain.

Property Tax Effects on Structures

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

The property tax on buildings hits well-constructed, high-quality, structures far more heavily per unit of floor space or cubic contents than do slums and "junk." The element of property taxation which falls on buildings creates an incentive against upgrading of quality, especially in those parts of older cities with most urgent needs but also with high tax rates. Such unintended and undesirable discouraging of private effort to raise quality does not come from the tax on land.

When his tax bill goes up because an owner has constructed a better building, he does not get correspondingly more better governmental services. But his investment will usually have produced advantages for others around. As compared with the old, deteriorated, property on which tax was low, the new, high-quality building will bring the general public positive "neighborhood benefits."

Would not wise public policy encourage better structures? Without deliberate design, the present tax favors buildings which produce bad neighborhood effects. The owner of dilapidated structures -- residential, commercial, industrial -- will be freer from economic pressure to replace with something better if his tax 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 toward the costs of government -- $1 more of taxes for each $3 (or even $2) of annual payment for the better facilities themselves.

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

Taxes and Maintenance

The quality of space within buildings available for work living will depend greatly upon the maintenance of the stock of older buildings. Under-maintenance forms one way by which an owner can reduce his net investment in a building. His actions in letting a building run down will affect others, the larger neighborhood. Deterioration of a minority of buildings can hurt a considerable area. Good maintenance can be combined with spending for improvements which have "spillover" benefits for the whole neighborhood.

Though often overshadowed by income tax and other considerations, property taxation has some influence on maintenance, adverse influence. The tax reduces the net return from the structures and thus the attractiveness of putting more dollars into such properties. Dollars paid to the local treasury are not available to finance maintenance. And 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 - Buildings and Land

The property tax on buildings adds to the cost of supplying them and to the price which must be charged. A heavy -- often 25 to 30 percent --

consumption tax on housing makes for materially higher cost. In this way the tax will reduce the amount demanded. One bad effect of this result is a hidden, or what economists call an "excess," burden. The tax on buildings, but not the tax on land, deprives the consumer of more real benefit than the dollars paid to government. 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, however, creates pressure for building smaller units. The result is less of what we really want in living room and amenities per unit of labor and materials used in construction. The tax does so 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 of land. If tax is increased, the amount remaining for the owner drops. The price a buyer will pay goes down. Government taxes take 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, a part of the yield or produce 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 increases in perpetuity. In practice, what he fails to get may be only a portion of what would be a rise due to social change. Land prices will vary inversely with taxes, other things being the same. But higher land taxes may provide better services of local government and permit lower taxes on buildings and by encouraging construction raise demand for land. The actual decline in land prices may over a period of time be less than originally expected -- or in some cases not actually develop at all because of greater demand of builders seeking sites.

Other Undesirable Effects of High Taxes on Improvements

High tax rates on buildings (and little reliance on land value) reenforce incentives for creating "island" of relatively low tax rates. 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.

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.

"Lower" taxes on buildings in the fringes encourage dispersal and the development "far out" of activities (including housing) which "ought not" to be so distant. Each increase in tax rate near the center will reduce the value of the property and the tax base. Many buildings in the older section will have deteriorated but yet have some "useful" life and a potential of prolonged decline before replacement. Owners of land with obsolete buildings delay replacement, in part because the speculative holdings of the land involves little out-of-pocket tax costs. The tax base tends to go down, aggravating the need for higher tax rates. Businesses become vulnerable to competition from outlying neighborhoods.

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. The disadvantages take the form of (1) costs in time and money of traveling greater distances from home to work; (2) higher expense of supplying water, sewer, and utility services over the far larger area; and (3) reduction in economic and social benefits which concentration of population facilities.

Basic Reform

A change in the economic framework would permit raising the same amount of revenue but with significantly different, and better, nonrevenue results. The basic principle is old. Mention of Henry George and his single tax proposal may evoke mixed responses. Without pretending to support the "single" aspect of such plans, we can look at the underlying principle -- but not attempting complete untaxing of buildings.

Progress will come from redesigning property taxation, not to reduce total revenue yield (for needs of local treasuries seem too great). The change would recognize and build upon the essential difference between land and buildings (as well as tangible personal property). Both the legal (constitutional) and the administrative conditions would differ from one state to another -- and among localities within each state. In effect, the tax rate on buildings and other improvements would go down and the rate on land would go up. Perhaps a 1 to 3 rate relation would be a reasonable goal.

Is the reform one realistically possible? I believe that it is. Practical problems of transition and administration would be substantial but worth the effort. The job can be done, not by wishing or merely changing a few laws. But by intelligently directed effort to recast an important element of the economic framework. As a result, local finance would rest on a fairer and more solid basis. The conditions and incentives guiding private investment in new buildings and land use would be modified, leading to results materially better than those today.