

TAXING FOR PROGRESS - TWO-RATE PROPERTY TAXATION

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Every community in the country uses property taxation. Schools, policing, and the many elements of local government rely heavily on property tax revenues. Typically, the tax (some hidden in prices) averages around three percent of Personal Income.

Property Taxation differs greatly from one place to another. Real estate makes up most--in some states, all-- of the tax base. And the real estate base consists of two elements that differ fundamentally--one is land, the other, man-made capital. This distinction has economic reality of profound significance. The quantity of land is fixed. The total space on the earth's surface does not depend upon the rewards offered. Man-made capital, the other part of the property tax base, does result from what human beings do, their work and thrift. The quantity of man-made capital to serve us will be influenced by the taxes on its creation and use.

The concern here today is not whether to use property taxes or how heavily but rather on the structure of the tax. And specifically, upon the relation to progress. The concept of "progress"? For present purposes let us say "more of what people choose"--foolish as some choices may be. The more the opportunities, the broader the range of choices available, the greater the progress. The title I chose should not mislead. Taxing will not make for progress. The way taxes are imposed, the structure of the revenue system, can make a difference.

Capital

Much of progress relates to, consists of, capital-- housing, utilities, factories, equipment, planes, and other tangible items as well as intangibles, notably human capital. Modern life calls for much more than most of us realize. Yet supplies are limited. Additions of new capital (the flows) reflect the prospect of net benefit. Net, after tax.

Property taxation drives a wedge between the product of property, the values it creates as measured by what the user will pay, and the amount the supplier will retain. Local government services may be directed to benefits associated with the buildings that are taxed. Fire and police protection may be cited. Schooling presents more complexities. How much of the benefit and how much of the cost of government services should be associated with structures and how much to land--location-- may not be clear. But more capital, whether housing or business production capacity, means more net benefit. Taxes that reduce additions of capital in a community impose burdens beyond those measured by the revenue yield.

Capital for new investment flows in a world market. Some may be essentially local. The "building and loan" associations of my youth epitomized the accumulation of local saving to finance housing in the community. Today's markets for new investment funds extend over the world. They are competitive.

Individuals or businesses seeking funds for new investment projects face competition from many sources. Their local governments can impose obstacles. Taxes. Governments may also provide services that attract. Whether hindrances or attractions, what counts will be the net effect. But taxes are not all the same per dollar of revenue. And they are not the same as prices.

Prices serve to get things produced and offered to users. And prices help us allocate--one thing rather than another. We pay to get things created--more for a four- than a three-bedroom residence of similar construction. Payment induces the supply, the production, of machinery or a consumer good.

Why state the obvious? Because of an important exception! Land. What is paid for land does not create land. Markets have a crucial role as regards land. But for land, prices play only one of the central roles of price--not inducing production because the production of land occurred in a past not being recreated. The role of prices in land markets is the other function of price, allocation. Guidance of choice.

Land Prices

Some land commands high price, others little. Some of the difference grows out of investments present and prior owners have made in sites. Such capital inputs get embodied with what nature created. Market forces guide such new investment. Much of what is paid today for urban sites exceeds, usually by far, what owners have done to improve the land.

Differentials in land prices, some enormous, serve the highly valuable function of guiding the allocation of land. Which of possible uses. The function has greater importance in our lives than we may realize.

Location.

The "where" of production and residency and recreation (to say nothing of movement and the resources of time and money in getting somewhere else)--location-- whether chosen well or poorly, bear crucially on human life. Land prices are not a result of costs incurred in production, but they do have a distinctive "time dimension," perhaps a permanent or "forever" element, sometimes for shorter periods.

Professor Gaffney has identified two dozen aspects of land and land markets that make them somewhat unique. Classical economics treated (pure) land rent as a residual. Correctly. Land rents in the economic sense are much greater than amounts so labeled in the national income accounts. For example, quite a bit of what is economic rent of property used by businesses will be treated as interest or profit. Moreover, the pure land rent element of housing occupied by the owner will not be identified as such.

Today we hear of more types of rent and rent-seeking. Think of rent as the (continued on page 9)

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payment in excess of what is needed to call the resource into existence. The skill of an actor, athlete, or inventor may yield rent-like return. And long-lived facilities may bring what are sometimes called quasi-rents (in the time before new capital flows add to the supply.) Mineral sources and the broadcast spectrum certainly have elements that are properly treated as is land in discussions such as this. Our concern is with the finance of (local) government.

Tax Something, There Will Be Less of It--Except Land

Taxes force people to do with less privately so that they can get government services. Tax something, people will buy less. One can quibble and try to think of exceptions. And there IS an exception--land. The quantity of space on the earth's surface was fixed by nature. The amount of housing in a community or the taxes the locality imposes on factories or offices or trucks will affect the amount available; most responses to any changes, of course, take time. And the responses will reflect the estimated worth of the fruits of the spending for those who have choice about paying tax or locating elsewhere.

Location has value. Some urban land commands very high rewards. The worth of location depends upon what goes on around, upon the community--including, but not limited to, things the (local) government does--streets, policing, schools, and so on. The value of buildings and machinery depends upon investment of present and prior owners in creating the assets. The worth of location, in contrast, depends upon what the community (broadly conceived) has done and seems likely to do in the years ahead.

Sometimes tax laws are designed to reduce an activity--smoking cigarettes or consuming alcohol. More typically, taxes, such as those on housing, are imposed without an explicit desire to reduce the activity. We know less than we would like about the results over the years of a tax change now.

But we do know that water flows downhill. Similarly, taxes will discourage.

Other things the same, a tax increase on housing will reduce construction. A tax on machinery will reduce the attractiveness of the area for new investment in machinery.

Mobility of Investment Funds

Local governments exist in a world in which investment funds are mobile. The well-being of the people in any community reflects the capital that has been invested in the past. And the future will depend upon the new capital funds invested--in office-building, utilities, factories, and other such production facilities associated with employment and the creation of income--housing included. Local officials recognize that the flow of dollars for new investment will take account of the effect of taxes. To attract new investment, local governments make tax deals of various types ("holidays," sometimes not disclosed with full clarity).

Competition among communities is real but quite unsystem-

atic. What one locality gets, others will lose. Overall, net revenue will suffer. And the "system" does not make up revenue losses by capturing more from land. Owners and occupants of existing structures will be worse off relative to what could be.

Land

My advocacy of two-rate property taxes has emphasized the desirability of encouraging capital investment--with higher tax rates on land to keep the net revenue unchanged. But there are also substantial merits in financing (local) government from land rents.

We pay for the use of land. But the space would be there even if we made no payment. Over the sweep of history--and in some localities, last week, even yesterday--land prices have gone up. Owners have benefited beyond any creative effort and investment they have made.

People getting rich while they slept, perhaps with inherited land! If such unearned increments could be captured to help pay for (local) government, wonderful! Alas, however, there seems to me less than slight prospect of any tax targeted on unearned increments being crafted and administered on a scale that would do much to pay for urban government. But increments become part of a broad property tax base. The greater the land portion of tax revenue, the more value increments would yield in revenue.

A central goal--revenue from taxes that do not tend to reduce and impair productive capacity, including housing. Less deadweight loss. Less burden that does not yield revenue. More benefits that are unseen, two kinds. One is the use of economic surpluses, pure rents, to help pay for some of government. The other is a reduction in deadweight burden, the adverse effects of taxation beyond revenue yield.

Property taxation today does tap some of the values created by community growth, including unearned increments. Here lies one reason why the property tax can be called rightly (with qualifiers and, of course, per dollar of revenue) "the best of taxes." And I repeat the merit noted earlier, this tax to the extent that it falls on land does not reduce the stock of productive capacity.

Allocation: The Use of Location

Human well-being depends not only upon the quantity and quality of productive resources but also upon how they are used, allocated, choice among alternatives. For land, one focuses on the location element. (Agriculture differs.) Each location is unique. Machines and houses and trucks can be duplicated. Not location. And what happens on one spot has significance for neighbors. Moreover, decisions as to use usually involve commitments for substantial periods.

A property tax payable in cash creates incentive to get some income. And normal market forces provide inducements for owners of land to (continued on page 16)

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find and to utilize the best opportunities. What do potential users desire? Market forces, however, may be inadequate. Knowledge will be incomplete. The community (broadly conceived) suffers when locations are not used to best advantage. The market has rigidities, many imperfections; the real estate market can be sticky. The general public has little way to express collective demand (wishes and willingness to pay). The two-rate system would enlarge the pressure of the land portion for optimum use. This result increases the desirability of the proposal. The general community, as well as the owner, has an interest in "highest and best" use of locations. The two-rate system would enlarge the forces of the market to make best use of land. And by reducing the tax burden on new capital investment, the two-rate tax would raise the demand for land.

Concluding Comment

Without knowing just what others on this program will say, I conclude with an assertion: There are persuasive economic reasons to increase the land portion of property taxation and reduce the burdens on man-made capital. After these notes were prepared, I received from Professor Steven Cord the draft of an impressive study. He has searched for examples of the use of the two-rate system. He reports that all the evidence, every case, gives empirical confirmation that, in practice, the two-rate tax will be associated with results that theorizing predicts.

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