Two-rate tax misrepresented

LOST CHANCE

A STATE legislative commission missed a golden opportunity to show New York how to reduce urban blight, unemployment and housing problems.

The Temporary State Commission on the Real Property Tax in its report to New York's governor and Legislature, "A Two-Rate Real Property Tax System: Its Impact and Implications for New State,"* recommends against the two-rate tax which is giving Pennsylvania cities such a dramatic boost.

Pittsburgh, Harrisburg, Scranton, McKeesport and New Castle imposed a seemingly simple change. They lowered property taxes on housing and commercial structures and raised them on community-created land values. They gradually increased tax rates on land until they were double and even six times the rates on buildings.

These changes, put to the test in the late 1970s and early 1980s during a steel crisis in the region and a national recession, as noted in *Fortune*, the *Wall Street Journal* and other publications, stimulated private downtown renewal, home-building and rehabilitation, and new jobs in construction and related fields.

The New York Commission does not entirely deny these effects. It admits "increases in development activity in these cities during the time periods analyzed was impressive." However, the Commission discounts the achievements, attributing them to "abatement policies" and "the Federal Tax Reform Act of 1981."

Prof. Steven B. Cord, who helped initiate and analyze the two-rate reform, replies that even cities without tax abatements for new buildings "experienced significant new construction" after introduction of the two-rate tax.

Edward Kardish, head of Philadelphia area homebuilders and a foe of the reform, told a 1983 tax conference that, despite its big abatement program, Philadelphia saw only six homes built the previous year while Pittsburgh experienced a housing boom.

The federal tax benefits enjoyed by all could hardly explain why two-rate taxing cities outperformed comparable cities, Cord notes.

This year, when special interests had to bow to the public interest in the federal tax arena,

By Walter Rybeck, Director, Centre for Public Dialogue, Washington

New York land speculators found champions in this eight-year-old Commission which operates on a half-million dollar annual budget.

Commission chairman George S. Gerber says the Commission found that effects of a two-rate in Pennsylvania "are disputed." That puts it mildly: the reform has its enemies.

The study's conclusion, in the same vein, reads: "... any serious thought of implementing a two-rate taxation system in any New York localities would have to be predicated on a detailed study of the impact of such a system on both an inter and intra-property class basis." In short, the study calls for a study.

"Most economists," claims the report, "have expressed opposition to land value taxation." L. Lowell Harriss, director of the Academy of Political Science, says Charles P. Kindleberger, respected economics historian and past president of the American Economic Association, finds on the contrary that most economists "have more than a touch of Henry George [the ultimate land taxer] about them."

Robert Clancy, president of the Henry George Institute, also took issue with Gerber. He quotes the most widely used textbook on the subject, *Economics*, by Samuelson and Nordhaus: "Our ideal society finds it essential to put a rent on land as a way of maximizing the total consumption available to the society. But these efficiency rents need not go to the privileged — they can go to the state (in rents or in taxes on rents) . . ."

Economist Mason Gaffney, University of California-Riverside, wrote the Commission that he was extensively quoted, "often verbatim," without attribution and, worse, that the material was used "in the opposite way from which I intended."

Also questionable are 69 pages of arguments against land value taxation with a disclaimer these do *not* necessarily reflect Commission views. It is as if a race relations study paraded every prejudice ever used to discriminate against blacks, with no judgment as to their validity.

Allegedly, for example, distinguishing land from improvements is a problem, yet the report's one positive recommendation calls on assessors to stop evaluating vacant land and the land under buildings "at a lower percentage of market value than other real property." Tax officials properly are urged to distinguish between land and buildings and to apply the same yardstick of value to both, as the best professional assessors and appraisers do every day.

If this praiseworthy recommendation is pursued, it will shift substantial tax burdens from buildings to land values. Why this sound and equitable policy is favored when it is called assessment reform, but not when achieved via differential tax rates, is not addressed.

The report relies extensively on a Pennsylvania Economy League (PEL) two-rate tax study undertaken for Pittsburg Mayor

● New York . . . the commission's report used questionable arguments

Richard S. Caliguiri who twice vetoed higher land tax rates. The Commission focuses on PEL's charge that, under the reform, wealthy residents get tax breaks at the expense of the poor.

Were this so, would City Council have prevailed twice over the mayor's veto? Would voters overwhelmingly return its prime sponsor, ex-Councilman William J. Coyne, to Congress and keep him as city Democratic chairman?

Would the U.S. League of Savings Institutions have found that in 1985 Pittsburg enjoyed the lowest median home prices among dozens of large cities? (Pittsburgh, $54,152; New York City, $129,700; Atlanta, $87,250; San Francisco, $152,000; Salt Lake City, $66,000; Raleigh, $73,825; etc.)

The Commission uncritically accepts PEL's assumption that most poor people own property in poor neighborhoods. The bulk of rental properties belong to affluent owners. Focusing only on Pittsburgh's low-income people who *do* own their homes, they save "at least $728,741" a year due to the two-rate tax, Cord found.

Another Pittsburgh study by Henry O. Pollakowski, "Adjustment Effects of a Land Tax," examines only property sales, disregarding investments made by present owners once taxes favor land *using* rather than speculation. The author cautions that this work "should not be used as evidence concerning the general advisability of increased reliance on land taxation," a warning the Commission disregards.

The Commission undertook simulations of the two-rate tax in Rochester; suburban Guilderland, in Albany County; and rural Root, in Montgomery County.

Guilderland, says town clerk Jane Springer, has 28,000 people, abuts Albany's town line, has a large shopping mall, no commercial center. "We have light industry, quite a bit of rental housing in apartments, some vacant land in the heart of town and a number of farms," she said.

Town supervisor John Zechnicki says Root has 1800 people, no shopping area, a lumber yard, little other commerce. "We're dairy farming country — but a lot of the farmers are giving up — can't get anybody to cut hay," he said. "I've got 100 acres idle myself."

Although it is unclear why Guilderland and Root were chosen for study, they set the stage for this predictable conclusion: ". . . significant tax shifting occurs in both the vacant land and farm land classes . . . The shift to farmland would run counter to State policy to both preserve and encourage agricultural production."

A community with the two-rate tax would indeed tax close-in farms more heavily, but land use experts recognize this as a way to conserve farmland. It fosters development of farms adjacent to urban services instead of farms beyond suburbia.

It discourages the road extensions, malls and exurban housing that are destroying true farming regions. It supports compact infill growth rather than the sprawl and speculation which have been enemies of both central cities and farmers.

Rochester, a city of 243,000, is a more likely two-rate tax candidate. With high-tech industries such as Xerox and Kodak, it rode out the storm that hit smokestock cities in much of the East. A heavily subsidized downtown renewal program nears completion. The city's plan director says 45% of residents live in rental housing, mostly in old homes subdivided into six to ten units.

Assessment data, supposedly geared to 100% of market value, formed the basis of the Commission's simulation of the two-rate tax. One oddity emerging from these data is that buildings account for 88.5% and land 11.5% of total taxable values.

Land in a healthy city tends to represent at least 30 to 40%. No wonder the Commission calls attention to underassessment of land. But in 17 variations of the data, which staff researcher Sam Stein says were proxies for other cities, the land portion never exceeds 18.88%.

In the simulation, residential data relate only to single-family homes. Multi-family dwellings are lumped with commercial and industrial and labeled "all other properties." Explained Stein: "We just didn't think it was necessary to have these as separate categories."

Lacking statistics on poor people's housing, the report nevertheless manages to translate zero data into one of the "conclusions drawn from simulations," namely: "While the residential class, in the aggregate, is benefitted, it appears that such

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Master realist

By DR ROGER SANDILANDS, senior lecturer in economics at the University of Strathclyde, Glasgow.

Stephen R Lewis, Jr (ed), *Henry George and Contemporary Economic Development*, Williams College, Williamstown, Mass., 1985, pp.95

THIS slim volume arose out of a conference organised by the Center for Development Economics at Williams College to assess the relevance of Henry George to fiscal and trade policy in developing countries. To this end four papers are presented. Roger Bolton, of Williams College, assesses the attitudes of economists, politicians and interest groups to Georgist rent theory and tax policy. Robert Conrad (Duke University) and Malcolm Gillis (Harvard) review developing country experience with mineral resource taxation and attempt to compare Georgist and "modern" concepts of land and natural resource rents. David Holland (M.I.T.) appraises the recent experience of Jamaica with land value taxation. And C. Lowell Harriss (Columbia) assesses the relevance of Henry George to the contemporary debates on protectionism versus free trade and the "incentive taxation" ideas of modern "supply-siders".

All of the contributors are sympathetic to the basic proposition that land and natural resource rents can be a more efficient and equitable source of state revenues than taxes on output and work. However, some contributors do not always do full justice to George's ideas. In particular, he is disparaged for failing to understand modern "marginalist" principles in economic analysis; for insisting that land is monopolised when we are all supposed to know, thanks to Alfred Marshall, that there is a competitive market for land; for failing to understand the modern "opportunity cost" concept whereby land has many alternative uses; and for not understanding modern portfolio theory in which land is only one of many assets that individuals can hold as wealth and which therefore must be given the "normal" rate of return earned on competing assets.

I believe Henry George would have had little difficulty disposing of all these criticisms, though it is true that George's famous debate with Alfred Marshall at Oxford in 1884 on land monopoly was unsatisfactory because of disruption from a disorderly undergraduate audience.

On the question of marginalism it should be noted that the essential feature of George's theory of rent, following Ricardo, is the declining marginal product of land which gives rise to a surplus over the costs of cooperating factors of production, labour and capital, on intra-marginal land where yields are relatively greater.

Competition ensures that the returns to labour and capital are equalised except for differences in skill, effort and risk. The general wage rate and the general interest rate tend to reflect what can be earned by the labour and capital that work on the least productive (marginal) land in use.

It was this analysis that inspired John Bates Clark to develop his famous marginal productivity theory in 1899, though unfortunately Clark saw no generic difference between land and capital. Bates thus missed the crucial point in George's theory that land is inherently non-homogeneous and fixed in supply whereas capital goods can be reproduced and moved around to ensure that the return to capital tended to be equalised at a level that just covered the real costs of production.

In this volume Conrad and Gillis, and Holland, both reflect the confusion Clark's approach engenders. In both papers there are diagrams that purport to show that "the" price of land is determined by the intersection of the downward sloping land demand curve and a fixed land supply. However this would only be "the" price of land if all land were homogeneous, like sacks of wheat or barrels of refined oil. Because these modern economists understand marginalism less well than George they then claim that land or natural resource rents can be measured by this same price for each unit of land, or the rectangle under the price line.

By contrast, Henry George explained that the last unit of land in use was capable of yielding only enough to pay the cooperant factors of production, labour and capital, their necessary competitive wages and interest, leaving zero surplus as rent on this marginal land. The area under Conrad and Gillis' "price" line is not rent but the total wage and interest payments to labour and capital. Rent is then the remaining (triangular) area under the demand curve because, with land in fixed supply but with heterogeneous attributes, each plot commands a different price.

Unless this is understood it is impossible to understand why a tax on rent will not directly affect the returns to labour and capital, which will continue to reflect their productivity on marginal land where rent, and hence rent taxes, are zero. (David Holland also has a misleading diagram that shows a land tax reducing the price of marginal land by shifting the land demand curve parallel downwards.) There would indirectly, however, be positive incentive effects for labour and capital if the rent tax replaced taxes on labour and capital.

It is also true, however, that Henry George was far less mechanical and mathematically rigorous than J. B. Clark in his approach to the marginal productivity of variable factors of production as their supply expanded while the supply of land remained fixed. But some would claim that

● Henry George

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benefit is not uniform and significant intraclass shifting would occur to the poorer property owners, making it more difficult for them to retain and maintain their properties."

Assessments show utilities — gas, electric, oil, phone — reflecting 11.27% of Rochester's taxable property. Because utility value is mostly in improvements, not land, the simulation shows utilities as "the major beneficiary" of a two-rate tax.

Economists like Harriss and Cord expect this would lead to reduced utility rates, benefitting consumers. Farbstein, however, George's approach gains from greater realism what it loses in mathematical precision.

George emphasised the dynamic economies of scale and technical progress which could offset the tendency to diminishing returns and raise the productivity of labour as population expands. However, while George did not use the term explicitly, a sympathetic reading of *Progress and Poverty* or *The Science of Political Economy* show that he was well aware that it was the average product of labour that is increased by technical progress while the marginal product of labour tended to be little changed. For this reason the gap between average and marginal product widened, thus increasing the absolute level of rent and, though less inevitably, also the relative share of rent in national income. In the absence of measures to redistribute rent progress would march hand in hand with poverty.

However, George, following the French physiocrats, was aware that ultimately taxes on labour and capital reduced rents payable to landlords. This did not, however, mean that rents did not exist, only that they could be transferred indirectly to government through a roundabout, inefficient and stultifying system of taxes on labour and capital that were eventually passed on to landlords who were forced to charge lower rents in order to sustain wages and interest at their natural levels. (A *direct* tax on rent would transfer rents to the community far more simply and efficiently. Thus Roger Bolton, for example, is unfair to castigate George for failing to predict a falling and relatively low share of *measured* rent in national income as development proceeds. George was more interested in the underlying, natural shares of national income than with the surface phenomena measured by national income statisticians.

On the question whether the land market is monopolistic or competitive, the answer depends very much on whether one approaches this issue in terms of "classical" real costs (the labour theory of value) or "neo-classical" opportunity costs. George would say that land and natural resources were created not produced; they are the free gifts of nature. There were no costs of production. In the modern economic theory of the firm a market is said to be monopolistic if the product price exceeds its (marginal) costs of production. In the case of land there are no costs of production yet intra-marginal land does command a positive price. Why then object to this rent element as a measure of the degree of monopoly in land?

Modern neo-classical economists reject this view because they emphasise opportunity costs as the measure of value. If a central city site would yield #100,000 a year rent as a cinema but #101,000 as a disco then "economic rent" or "transfer earnings", on modern definitions is a mere #1,000 and George's radical view of rent conveniently disappears.

Similarly, in order to equalise the returns on various assets it is necessary that the value of land be capitalised and exchanged at the normal rate of interest. Otherwise there would, claim Conrad and Gillis, following Feldstein, be a "distortion" in the allocation of investible funds, or savings, or between land and other assets in individuals' wealth portfolios.

In *The Science of Political Economy*, which Lowell Harriss alone among the contributors to this volume appears to have read, Henry George devoted around 200 pages to explaining that what is wealth for the individual is not necessarily wealth for the society. In modern jargon land is not a currently produced article of wealth but a stock which can only be exchanged through "transfer payments". It is a fallacy of composition to state, as do Conrad and Gillis, that when an individual "saves" is income by buying land rather than, say, ICI shares then society has also saved more in this form. It is thus unfair to claim that George forgot the "general equilibrium effect" of individuals' portfolio choice.

The appeal of the modern theory of rent stems, I believe, from a fear that if rents are taxed away there would be no pricing mechanism to ensure that land is allocated to its most efficient uses. This fear is groundless if rents, as defined by Henry George and Ricardo, were all subject to the same percentage rate of tax. The decision whether to operate a cinema or a disco would then be unaffected by the tax since the relative operating costs would be unaffected.

Land value taxation does not remove the rationing function of rents as prices that reflect the relative scarcity or desirability of different types of site. It does, however, fundamentally alter the role of rents in the distribution of income in society between landowners, workers and capitalists in favour of the latter two. Rent taxation does not abolish rent, it merely changes its beneficiaries. In so doing, as Lowell Harriss is particularly eloquent in explaining, this change removes the shackles on industry, enterprise and thrift and promises a fairer and more dynamic society.

called utilities "one of the biggest problems we ran into — if utilities didn't lower rates, citizens and taxpayers would be up in arms against anybody suggesting this tax reduction."

The simulations "revealed significant, unpredictable class tax shifts would occur . . ." and that some of these shifts "may run counter to state programs." Of course there are tax shifts, taking away privileges afforded to those who use productive sites inappropriately.

Why, if the Commission designed the simulations properly, are the shifts called "unpredictable"? As to state programs, they surely are not designed to favor blight and sprawl, as present taxes do.

Under the impressive heading of "Analysis of the Economic, Socioeconomic, Legal and Administrative Arguments . . .," the report states:

"It is uncertain whether the alleged benefits of land value (or two-rate) taxation are worth the possible trade-off disadvantages of the arbitrary losses landowners and other [sic] could suffer as well as the general confusion of transition to such a study."

Far from arbitrary, the tax losses are shifted off good land users to land abusers. A clear virtue of the two-rate tax is that it avoids "confusion"; it is imposed gradually and works so smoothly that, as Scranton's mayor said of the two-rate tax, "We're really used to it — people don't even realize we have it."

Farbstein insists the study was undertaken with no hidden pressures. Its point on equitable assessments is well taken. Perhaps the discussion it engenders will let legislators reach a clearer perspective than that presented in the report.

** Copies available at no charge (in U.S.) from Temporary State Commission on Real Property Tax, 74 State St., Albany, NY 12207.*