

Property Taxation: Economic Aspects



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TAX FOUNDATION, INC.
50 Rockefeller Plaza
New York, N. Y. 10020

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By C. Lowell Harriss

The property tax plays a role in today's government finance large enough to surprise many observers. The tax takes more from taxpayers than ever before (*per capita*, in *dollars of constant buying power*) — and brings more into local government treasuries, nearly \$25 billion this fiscal year; about \$140 per capita, or \$700 for a family of five on the average (up from \$53 and \$415 respectively in 1965 dollars in 1965¹). The outflow of expenditures, however, has risen more rapidly.² Such will continue to be the case. In many localities, property-tax yields will not grow so rapidly as local government spending, allowing for grants-in-aid, etc., unless effective property-tax rates keep rising. But even if "adequate" rate increases were possible constitutionally, politically, and economically, they are not assured. Nor would increases be desirable where rates are already as high as in some localities.

Every tax has effects other than those

of taking dollars from the taxpayer and giving them to a government treasury. The adverse nonrevenue effects can be of more than minor significance, most certainly when the tax rates are at the high levels found in numerous communities today.

For local governments the property tax can compare favorably with alternative revenue sources — within limits. It shows up badly, however, when used as intensively as in a relative few (but important) communities today. Poor administration plagues the tax more generally than is necessary. Achievements in numerous places have demonstrated that administration can be improved. And the structure of the tax could also be much improved. This paper will not deal with one structural problem — the taxation of personal property. Another structural element, the relative reliance on land and buildings, will get attention later.

What the Property Tax Is—And Is Not

The property tax falls on *people*. "Things" do not, in a meaningful sense, bear tax. The property tax must be thought of as a device to tax people according to their ownership, use, and other ties to property. The tax is almost

exclusively a source of revenue for *local* government. In four states only real property is taxed. Most states, however, permit localities to tax tangible personal property — machinery, inventory, furniture, etc. In fact, however, as

1. For discussion of reasons for growth of spending see C. Lowell Harriss, *Handbook of State and Local Government Finance* (New York: Tax Foundation, Inc., 1966).

a rule only the personal property of businesses and automobiles are taxed. In a few states there is still more than hit-or-miss taxation of intangible personal property — securities and bank balances.

The tax is *not* a levy on individual net wealth. The justification for the tax does not rest upon a presumed adjustment of burden to a person's net worth. The base of the tax is an estimate of the worth of each particular piece of property, chiefly real estate, without regard for any debts against it. In almost all cases *assessment* and *collection* are local functions. Many state constitutions, local charters, and state statutes governing local affairs prescribe maximum tax rates. Their practical effectiveness differs widely.

Although property-tax rates when expressed as a percentage are small, they *apply to capital values* and are often "high." Comparison of property-tax rates with income or sales-tax rates can be deceiving. A 3 per cent property tax equals 33 per cent of the pre-tax income — and half of that after tax — from a

property which yields 6 per cent to the owner. An increase of 0.5 per cent would reduce the amount remaining after tax in such a case by about 5 per cent. The property tax differs in essentials from an income tax. Each should be judged according to criteria applicable to it, not to the other.

The tax in most localities is largely a burden on *housing*, but substantial amounts are collected from businesses. When expressed in the same terms as a retail sales tax, the property tax equals 30 per cent of pure occupancy cost of housing in some localities. In a *vital economic sense*, the property tax on real estate is not one tax but two of crucially different natures — a levy on *land* and one on *improvements*. The condemnatory comments which make up most of what follows apply chiefly to the second aspect, that is, the burden on improvements. The tax on pure land values, according to a long and respected — and correct — tradition of economic analysis stands as one of the best possible means of getting local revenue.

A Powerful Argument Favoring Property Taxation

Property taxation deserves support for a reason sometimes slighted by critics: the tax pays for benefits going to those who bear most of the burden. True, we cannot relate the tax paid by any particular renter or homeowner to the benefits of local-government spending which he receives. For the group, however, the case is clearer. The tax which is collected locally and spent locally goes to benefit the people of the area. Thus, payment of the cost of government conforms closely to benefit on an area basis. In this respect is not the property tax result *fairer*, more *equitable*, than in the case of state and

federal finances generally? Conclusions may differ: "spillovers" can be cited to require modification of the central point. Yet the basic validity stands.

Equity is not the only relevant criterion. Efficiency in resource allocation is another. The allocation of resources will tend to conform more closely to public preferences when both tax and spending are local than when one is decided at a distance from the other. The argument here applies with less complete validity to very large cities than to smaller communities. Yet its basic merit extends broadly indeed over the country.

Who Really Bears the Ultimate Burden Of the Property Tax?

To judge a tax wisely, there is need to know who really bears it; he may be a person very different from the one who writes the check. Sometimes when taxes are shifted—from building owner to tenant—the process works rather clearly. Often, however, the process is both obscure and slow. The summary here must be somewhat dogmatic.²

A change in tax will fall on the owner or user, depending upon contract and market conditions. With the passage of time, the incidence can change. Of the portion of the tax rate which will have been in effect for some years—that is, most of the rate—the burden on *structures* is borne by the user.

The tax on land values reduces the worth of land. In effect, the owner at the time of each jump in tax rate will have suffered a loss of capital value. Consequently, present users of land as they pay tax are not in fact truly worse off by the amount they pay. If the tax were lower, they would have paid a higher price or rental rate.

The search for tax equity rests upon the best of instincts. Taxation represents government's use of coercion. And all use of compulsion should be just. But what constitutes fairness in sharing the costs of government? Would further increases in property-tax rates be a fair way to finance the rising cost of local government? "Fairness" has more than one aspect. My comments, once again, are summary.

The property tax runs counter to one concept of fairness by burdening low-income groups more heavily in relation to income than those with larger incomes. A *regressive* element exists. And regressivity is generally believed to be inequitable, conflicting with "vertical equity." Men of goodwill can disagree in the degree of their condemnation of regressivity as such. But all will probably be distressed to learn how heavy are the property tax burdens on persons with low and modest incomes, where property tax rates are as high as in some cities. In this case, however, the benefits paid for by the tax have a very large "pro-low-income" bias. Moreover, the great bulk of the revenue comes from taxpayers in the income range in which the burden is not so much regressive as roughly proportional.

Still another source of criticism of high property taxes lies in "horizontal inequity": taxpayers within each income group do not receive essentially similar tax treatment. In every community some families are required to pay more property tax than do others with about the same income and in generally the same circumstances. But communities have it within their power to reduce such inequalities substantially.

Properties of the *same type* (six-story apartments, gas stations, or department stores) are treated differently. Assessments sometimes vary greatly *from one type of property to another*. Assessment

2. For a more complete analysis see W. J. Shultz and C. Lowell Harriss, *American Public Finance*, 8th ed. (Englewood Cliffs, N. J. 1965), Chapters XVIII and XIX. The discussion in the present paper omits reference to the effects of deductibility for purposes of income taxation. They modify the strictures somewhat—in amount but not direction.

inequalities are probably greater than the corresponding inequalities tolerated in other taxes. Not all taxpayers have equal opportunity to get a property-tax assessment *reviewed for possible correction*. Although "on paper" every owner has the same access to facilities for appeal, the real-life difficulties vary greatly. Among the low income groups, those who live in private housing will pay more property tax per family than those who live in "public" housing.

The property tax runs counter to one concept of fairness by burdening some types of consumption more than others. Burdens vary according to patterns of consumption. For example, families which choose to use above-average portions of their income for housing pay more of the cost of local government.³

These aspects of horizontal inequality leave no doubt that the property tax would not show up as a model of fairness in the distribution of burden among families. With the better quality of administration which is possible, it would score markedly better in most places than it does today.

Inducement to Smaller Structures: Sacrifice of Potential Benefit

The property tax on buildings produces rarely recognized effects which impose hidden burdens on the public—what economists call "excess burden." The tax deprives the consumer of more real benefit than the dollars which are paid to the government. The source of

this hidden loss can be explained, but the amounts cannot be measured.

The expense per cubic foot of construction of residential units declines as the size of the house, apartment, or other unit increases.⁴ In terms of one of the major things generally desired in housing—cubic contents—unit cost drops as room size increases. One estimate, for example, finds that if the cost per cubic foot of a more or less typical, good quality, single family residence of 1,000 square feet is 100, the cost per cubic foot for the same type of construction goes up to 115 if the unit has only 700 square feet and drops to 56 if the size is 1,600. For another type of construction, with 1,000 square feet size as 100, the cubic foot cost is 23 per cent higher for a 700 foot unit, and 20 per cent less for one of 1,400 foot.

The decline in construction expense per unit of space reflects the fact that cubic content rises more than proportionately to floor, wall, and ceiling area. Moreover, much the same plumbing, wiring, kitchen, heating, and other facilities can serve larger as well as smaller rooms and buildings through a range of sizes. The general public welfare can be served best by the construction of rooms, houses, and buildings of larger, as opposed to smaller, size. The property tax, however, by adding to occupancy costs creates pressures for building smaller units; in doing so, the tax makes for poorer resource allocation.

A study of family spending shows that, as one would expect, the higher the price of housing, the *smaller the quantity*

3. Retail sales taxes exempt rentals; even after allowing for indirect effects, one finds housing taxed lightly under sales taxes. The income tax treats owner-occupants favorably.

4. W. A. Morton, *Housing Taxation* (Madison: Univ. of Wisconsin Press, 1955) develops the point.

ity of space purchased. Similarly, the *quality*, the amenities, enjoyed will be less as their cost goes up. The property tax by adding to price will reduce the demand for both quantity and quality. Each one percentage point of higher housing cost leads consumers to settle for about one percentage point less of quantity, including amenities.⁵ Averaging over the years, it seems, the dollar amounts spent on housing by a family of given income will be about the same whether tax is high or low. To make up for a higher price due to tax, however, the *amount* and *quality* of space obtained will be curtailed.

Over time, therefore, the property tax—through the effects on demand—will lead to the construction of rooms, apartments, and buildings somewhat smaller than would be built in the absence of tax. The smaller units are not so good and yield less utility per unit of input. "Excess burden" results. The public unknowingly deprives itself of opportunity to exploit fully the potential benefits from "law of the cube." Thus, the public bears a hidden burden by sacrificing the benefits of greater economies in construction, per unit of space and quality.

An illustration will be helpful. Assume that a family would spend \$2,000 a year on housing. In a market free from housing taxes, it would get that amount of pure occupancy. But in fact the tax is 30 per cent. Then the total cost for equal facilities would be \$2,600. However, out of \$1 spent, around 73 cents goes for housing and 27 cents for tax. The family spends \$2,000, of which \$1,533 is for space and \$467 for tax. The physical amount (allowing for quality) of hous-

ing must be smaller because of tax. (We ignore the land portion of the tax.) In essence, resources are freed for use in providing government services. But per unit of input—the materials and labor used in producing such space—the units costing \$1,533 per year before tax will provide less in cubic contents, less of what people want, than if taxed in producing housing units to cost \$2,000 annually. The real resources produce less of what people want than would be obtainable. What government can do with the resources it gets will scarcely make up for this indirect loss.

The past will not be done over. The public must live in housing whose quality has been adversely influenced by effects of the tax in the past on types of construction as described above. The future, however, is ours to make. Being forewarned, society can try more rationally to avoid avoidable errors.

Taxation and Housing Quality: Maintenance versus Deterioration

Most Americans must live most of their lives in "not new" housing. Much will have been built before their birth. Housing will gradually lose its ability to provide satisfactory shelter unless labor and materials are devoted to offsetting the effects of time and use. The quality of the residential space actually available will depend greatly upon the maintenance of the stock of housing. Unfortunately, much of it is already poor, not only because it was "inferior" when originally built, but also because it has been allowed to deteriorate more than necessary. Under-maintenance forms one way by which an owner can reduce his

5. Dick Netzer, *Economics of the Property Tax* (Washington: The Brookings Institution, 1966), 63 ff., drawing on Margaret Reid, *Housing and Income* (Chicago: Univ. of Chicago Press, 1962).

net investment in a building. His actions affect others.

The maintenance done, or not done, on even a minority of properties can materially affect a larger neighborhood—for ill or good. Outlays for maintenance can be combined with spending for improvement. Over time, the owners (and occupants) of housing may do more than merely preserve earlier quality. Good effects due to betterment will "spill over" into the neighborhood. Any reasonably complete social system for making the best of the huge stock of existing structures will assign key roles to the prevention of new deterioration and the avoidance of discouragement of improvement.

High property taxes on buildings work against us on both counts. The influence is a matter of degree, of course, and in most communities will be little if any worse than one must expect in one way or another from any tax. It is in older cities with high rates, however, that adverse effects can become deplorably large. How? Property taxes influence maintenance in three ways. Tax payments reduce the net return from property and thus its attractiveness as an investment. Owners who rent out some of their properties but do not get a satisfactory return on investment will naturally be sensitive to taxes as a cost. Any increase in tax will be especially onerous if a considerable time is required for full shifting to tenants. The incentive to make outlays needed for maintenance will hardly benefit. Any force depressing net yield will probably induce some decline in the supply of housing by under-maintenance as it re-

duces average quality.⁶ The dollars used to pay tax are not available to finance maintenance. Owner-occupants, for example, cannot use the funds which go to the local treasury to keep the property in good condition.

The owner may believe that maintenance expenditures will lead to higher assessments. The higher the tax rate, of course, the greater are likely to be his fears and thus, also, his incentive to avoid actions which may raise his assessment. Purely maintenance outlays should not affect assessed values except by influencing the rate of deterioration over time. An owner seeking to act in a logical way would not be deterred by real estate tax in maintaining his property if such investment offered the best after-tax return. In fact, however, misconceptions can exert undue influence. With or without good reason, the owner may fear that a "repair and maintenance" job having visible results (or even one reported to the authorities for getting a building permit) will result in an appreciable assessment increase.

High property-tax rates on buildings do seem to deter maintenance even more than rationality would justify. And the types of maintenance which owners do make are not those which are wisest economically, structurally, or aesthetically and socially. Owners seem to favor forms which are not likely to trigger an upward reassessment, e.g., "inside" as against "exterior."

Many owners of real estate are not well versed in property management. Many suppliers of rental housing own one or a few properties—a two- or four-family building acquired as a home and

6. See James Heilbrun, *Real Estate Taxes and Urban Housing* (New York: Columbia Univ. Press, 1966).

a source of rental income, the place where the family business is carried on, inherited property, etc. Their attitudes, beliefs, information, and financial capacities will, of course, differ in almost every conceivable way. But we can be sure of one thing: the cumulative effect of their decisions about property maintenance will have a material effect on

the quality of urban housing. When a recent survey asked tenement landlords about the factors which determined their outlays for maintenance and improvement, the replies indicated that rising tax rates had hindered maintenance by reducing the income from investments and by adding to the fear of upward reassessment.⁷

Perverse Character of Burden in Relation to Cost of Government

The property tax as it applies to structures (not the portion falling on land) distorts resource allocation perversely where there is older property, especially in urban areas. New, well-constructed, high-quality buildings are taxed far more heavily per unit of space than slums and "junk." Can justification for such discrimination be found in the cost differences which the two types of property and their occupancy impose on local government per unit of space? Most probably, no—just the contrary. The badly run-down and less heavily taxed building is more likely to be associated with the greater costs, if only for fire and police protection.

The social and economic evils associated with slums should not be ignored in this connection; but the cause-and-effect relations are complex. Neither poverty nor public assistance and similar welfare outlays are assumed here to be either a cause or an effect of low-quality housing in any simple relationship. A valid conclusion, however, will stand: When high- or low-quality buildings are being compared according to the sort of calculus recommended by economists—matching benefits and costs,

private and public—taxes do not help to harmonize for society as a whole.

The user's payment for the services of local government goes down, relatively, as the building gets worse, even though public expenses attributable to the property are unchanged or may even increase. The "junkier" the building, the less the payment for government irrespective of expense to the government. In short, the tax element of cost of occupancy operates perversely as regards government costs and benefits. Occupants who put the community to relatively heavy expense pay less in tax, other things being the same, than the occupants of higher quality buildings.

The person who wishes to shift from poorer to better quality housing, or business property, cannot do so without also paying more toward the cost of governments—\$1 of taxes for each \$3 to \$4 of pure occupancy expense. Ordinarily, however, such a shift to better facilities will not add to services received from, or the expense to, government.

The property tax on structures creates an incentive against upgrading of quality in just those parts of older cities

7. See George Sternlieb, *The Tenement Landlord* (New Brunswick: Rutgers—The State University, 1966). For analysis of the theory see Heilbrun, *op. cit.*

where need seems greatest. Such discouraging of private effort to raise quality serves no useful public purpose. The tax on pure land element, in contrast, can work to hasten putting land to better use by replacing old improvements

with better ones. The two aspects of the property tax noted above have, in a highly significant sense, been reversed from the roles which would be optimal. Fortunately, reform seems well with our power.

Obstacles to Urban Renewal

Heavy taxation of new buildings must stand as a tragically apt example of mankind creating needless obstacles for itself. Cities which urgently need to replace obsolete, decayed, degrading buildings nevertheless put powerful tax impediments in the way of progress. Nobody planned to set up a tax system with such influence. No one tried deliberately to base local finance on a tax that would favor holding on to the decrepit structures, many of which spread evil influence through a larger area, while penalizing the new, the good, the source of benefit to a whole neighborhood.

An annual tax of 3 to 4 per cent on full value is high in relation to what most property produces—30 per cent of gross income, sometimes more. In relation to net income, of course, the burden looms larger.

Let us look further. If the construction of a new building requires demolition of an old one, the cost which the builder faces will include not only the land and the new construction; his expenses will also include the value remaining in the old building plus demolition costs—a sort of deadweight burden.

Let us assume that a new building will have a life of sixty years. Its construction involves the owner in a com-

mitment to pay property tax for each of sixty years. The magnitude of these future tax obligations can be expressed in terms of today's dollars. For doing so, each of the sixty tax bills must be discounted at some rate of interest to compute the present worth. If one assumes 5 per cent and a tax rate of 3 per cent a year on the construction cost, making rough allowance for reductions in assessment as the building ages, then the *present value* of the taxes due over the life of the building will equal about 50 per cent of the construction cost.⁸

Whatever the precise figures in a particular case, the property tax bill on a parcel goes up when a new building replaces an old one. The more that is spent for quality, etc., the larger is the new tax liability. And, of course, the higher the tax rate, the less the desirability of putting funds into new buildings. The property tax on structures, in short, creates a clear, and at present rates in some large cities a substantial, bias against the replacement of old buildings by new ones.

The amount of tax on land will not affect the quantity in existence. The tax on land can influence the availability and the use made of particular parcels.⁹ Any under-assessment of land will actually curtail incentives and pressure for urban

8. M. Mason Gaffney, "Property Taxes and the Frequency of Urban Renewal," *Proceedings . . . National Tax Association . . . 1964* (Harrisburg: National Tax Association, 1965), pp. 272-285.

renewal. In practice, it seems, some such inappropriate under-assessment may follow from implicit or even explicit attempts to transmit to the land the depressed valuations which are properly attributable to the deteriorated condition of the structure. The motivation for such assessment practices may seem commendable—but not the results. The effect in reducing pressure on the owner of the land to use it more productively will be to slow area renewal even more than does the property tax when it operates "normally." For in this respect the difference between the two elements of real property taxation—land and buildings—has great significance.

Property Tax as a Business Tax: Competition for Industry

The property tax is not merely a tax on housing as a form of consumption. The tax also falls on business, affecting both prices and the processes of production. In other words, it influences both the quantities of productive property demanded for use and business decisions on *when, where, how much*, and in what *forms* to operate and to invest in productive facilities.

The influences which grow out of tax considerations will rarely be constructive in the sense of helping companies to produce more efficiently. In general, tax-created additions to business-operating expense are undesirable.¹⁰ Businesses are overwhelmingly the source of income. In taxes, however, they encounter impediments—costs for which there are usually no identifiable aids to pro-

duction. Unlike wages, for example, property taxes do not pay for services received by businesses and thus helping to create income. Lawmakers bend to powerful temptations to tax people indirectly through business, rather than directly on their receipt of income or use of it in consumption.

The significance of property tax for business will depend in part upon the relation between the tax and the governmental services. Most services provided by local governments—education, welfare, sanitation, protection—are more for the consumer than for business as such. The expenses of city government are not of a type to be, in large measure, of any direct benefit to business firms.¹¹

Managers must take account of property taxes in making business decisions, such as where to *locate*. Most location decisions affected by property tax are not individually dramatic—perhaps scarcely identifiable—but in total they can be significant.

Some businesses, of course, are firmly attached to a location, e.g., those providing local services. They will not leave if the tax rate goes up, but their growth or decline will be affected. Firms which deal in highly competitive markets cannot afford to incur avoidable costs which do not, in return, either yield a salable output or reduce other costs.

Each rise in property tax unless clearly matched by improvements in local services to *business as such* tends to reduce the business use of structures because an element of cost has gone up. The amount

9. *Ibid.*, p. 280.

10. For more complete discussions see Committee on Federal Tax Policy, *Financing America's Future* (New York: The Committee, 34 West 51 St., 1963), Ch. III; C. Lowell Hattiss, "Taxing and Untaxing Business . . ." *Tax Review*, Vol. XXVI, No. 1, January 1965, Tax Foundation.

11. Businesses do not, of course, have the right to vote. Managers, owners, employees, and consumers will have no vote in some localities which seek to tax them.

of production in the locality will tend to fall below what would otherwise be the case, going down, not at once, perhaps not observably, but gradually. In a generally expanding economy, the effect in most localities would be a slower growth rather than any absolute decline.

The community with tax rates on buildings generally in line with rates elsewhere will probably not experience appreciable competitive loss of business. Where rates are already much above average, the long-run dangers are quite another matter.¹² Easily exaggerated? Yes. But also easily "assumed away" when in fact they will persist. Along with other elements, they will operate gradually, in amounts not measurable but certainly unwelcome.

The competition among communities for industry grows. Some competition takes the form of property tax favors, occasionally out in the open, but often concealed in the form of assessment fa-

voritism. No locality can escape such competition. Naturally, communities would like to be able to include within their boundaries companies which would pay high property taxes while selling outside. People elsewhere, in effect, would then pay some of the costs of local government where the plant is located. Competition, however, limits the possibility of one locality's getting much revenue from non-resident consumers. Each of the countless communities granting property tax favors, in a sense, "tells" the potential consumer elsewhere, "You can buy products created by factories, or services rendered, within our borders without paying (much) toward the cost of *our* local government." Whatever one may think about the desirability of such policies, they exist. Communities which do impose high taxes on the reproducible property of businesses are less able to maintain and build their economic base by attracting industry. Any tax on business will have such tendencies—except a tax on pure land values.

Tax Islands and Central City Difficulties

Differences in full-value tax rates among localities have other nonrevenue results. One, though related to business location, must be distinguished. Rates much above average in one locality will do more than discourage business investment there. The high rate will also reinforce opportunities and incentives for creating "islands" of relatively low tax rates nearby.

Among the numerous localities in the general area, a few with tax resources which are much above average in relation to service obligations can get by with lower tax rates. They can attract investments and become low-tax enclaves, perhaps predominantly industrial and commercial. The firms operating there thus incur little property tax per unit of output. They get something

12. The use of the "extra high" tax dollars must affect the results decisively. If differentially high expenditures go for services which the people making the decision about business location want and are able and willing to pay for, high taxes will not have the bad results described in the text. But as the text indicates, the benefits from local spending do not go so much to businesses as to families. Differences in quality of local education will be significant for employers. Yet will not wage rates be higher where schooling turns out more productive workers? Probably so. Will wages be enough higher to offset all potential benefits which business may have expected from higher property taxes for better schools? The answer does not seem clear in theory, and empirical evidence is not available.

of a competitive advantage while contributing little to help pay the expenses of local government anywhere. The number of such localities must be tiny, in relation to the economy as a whole; but particular cases can be of importance for a metropolitan region.

Other communities with autonomy over taxes, perhaps by the use of zoning power and building codes, are able to exclude types of property associated with high governmental expense. They may, for example, prohibit high-density housing which brings many children, and heavy school costs, per acre. The parts of a metropolitan area which succeed in such policies can hope to finance relatively high-quality local service with a property tax rate which is less burdensome than the rates nearby. The latter rates, however, tend to go up; or services are at a lower level. The advantages of freedom, and the opportunity for differences in ways of living, must be recognized as having less welcome results because of competition.

As regards buildings but *not* land, lower tax rates here and there on the fringes of an urban area encourage dispersal and the development "far out" of activities, including housing, which in a full economic sense ought not to be so distant. Property nearer the center will be subject to high tax rates; and each rate increase reduces the value of the property and the tax base. Much will already have deteriorated but yet have years of useful life, and of prolonged decline, before replacement becomes economical. As the tax base goes down, such decline in itself adds to the need for still higher tax rates. Business properties, especially commercial, become vulnerable to competition from

outlying neighborhoods, aggravated by forces which are encouraged by tax differences.

Unless the users believe that the benefits of local government go up with tax obligations, the repelling forces gather strength. A destructive process gains force, one somewhat self-reinforcing, but perhaps scarcely perceptible from one election to another. The existence of enclaves where tax rates on structures are relatively low, "tax islands," does more than harm neighboring localities and accentuate the difficulties of older areas. The whole region may suffer. Such taxation tends arbitrarily to favor *horizontal* over *vertical* growth in metropolitan areas. High taxes on land, however, do not have this type of effect but rather the contrary.

The higher the tax on buildings in the city center (or some part of the whole), the greater is the inducement for families and businesses to move to "tax shelters." Other residents of the area who also wish to escape the urban center (for reasons among which taxes may, or may not, rank high) must then "leap-frog" over the enclaves with their policies of exclusion, going further out. The resulting land use imposes higher costs on the whole society than if the population were spread more rationally. The extra disadvantages take the form of costs in time and money of traveling greater distances from home to work (and for recreation and perhaps schooling); higher expense of supplying water, sewer, and utility services further from central locations; and reduction in the economic and social benefits which population concentration brings.

The tendencies may be of small force

in the total economy. They ought not to be ignored, however. Nor should we overlook the possibility of counteracting

them by rearranging the tax to shift burden from structures to land as indicated later.

Encouragement of "Socialization"

High property-tax rates stimulate somewhat the expansion of the scope of governmental activity by giving misleading signals of the relative desirability of governmental, as compared with private, ownership. The property tax now channels one-fifth to one-third of what the occupants pay for the use of property into treasuries to finance governmental services. The higher the tax portion, the smaller the amount which remains to pay the expense of pure occupancy costs, including return on investment. Property taxes by affecting the net return on private investment in buildings will reduce supply. Because the tax forces occupants to pay more, it reduces the quantity and quality of space used below what would otherwise prevail. Such tendencies, however, will lead men of good will to search for something better. Can we not provide buildings whose use will cost less? Yes. One way to do so will be to free the user from the need to pay the full property-tax element. But how? Governmentally sponsored (tax exempt) projects seem to offer an answer. (Exemption from sales tax on materials for new governmental buildings will tend toward the same result.)

The argument will not ordinarily be, "Let's finance and build in ways which permit users to escape costs of government." More likely, advocates will say, "Costs can be kept down by tax exemption." The "saving" in costs, however, saves the public absolutely nothing in the sense that schools, streets, or other facilities can be less expensive than they would need to be if the building were taxed.

A shift from private to governmental ownership by exempting some property, however, will tend to bring heavier tax rates on other property. Electric and other utility services can give rise to much the same argument. Sponsors of municipalization of public ownership can hold out the prospect of providing something at less cost than can the tax-paying supplier if—and the "if" is important—the respective contributions to the cost of government are ignored. A difference in money costs between the alternatives—governmental and private ownership—induces distortion and misallocation. Private ownership yields more than the services involved directly. It also helps pay for governmental services.

Pressure for Exemptions

The growth of exemptions from property tax properly arouses concern. The reasons for granting exemptions differ. Some groups, we often feel, deserve help; one way to provide it is to grant tax exemption.

Who, for example will not sympathize with an old couple living on a modest income which they have no opportunity to raise and who are called upon to pay ever higher property taxes to finance school expansion? Although the tax it-

self may not, in fact, be a large part of the source of distress, it can be a focus of pressure for relief. Here is something government *can* control. Agricultural land on the urban fringes presents another type of case which sometimes seems to call for relief when taxes as well as values go up; but the issues and desirable policies are by no means so simple as may appear.

To lawmakers—and the public—granting relief in the form of tax exemption

can appear easier than an increase in expenditure directed toward the particular need. In fact, however, exemption tends to be a crude and inefficient device in that the benefits provided to those in real need are small per dollar of revenue loss.

Be that as it may, pressures for relief from property tax will grow if tax rates go up. The higher rates aggravate the problem and enlarge the effective worth of the exemption.

Land Versus Improvements

As noted earlier, "the" property tax can be thought of better if one wishes to analyze the economic aspects as *two* levies, one on land and one on improvements. High property taxes will *not alter* appreciably *the amount of land in existence*. But will the height of the rate influence the use of land? If so, how? The higher the tax rate on land, the greater will be pressure on the owner to put the land to the "highest and best use." Society can actually benefit from a tax other than merely getting funds to pay for government.

A point of great significance seems valid today as it was even before Henry George wrote so eloquently. The extravagance of the claims of some advocates of the Single Tax or site value taxation have hurt a good cause, namely the effort to distinguish between the economic effects of tax on land from those on improvements. Different results must follow from the two.

Every decision involving the construction or use of real property must be weighed against the tax results. The greater the tax, the smaller the number of investment projects—and the smaller

the number of dollars put in each—which will yield a satisfactory after-tax return. Less housing in quantity and quality, and less investment in other types of buildings are to be expected—assuming, as seems reasonable, that alternative uses of savings are available.

If the property tax were a minor element of expense, any possible discouragement of new construction would cause little concern. But the tax already looms large—and provides incentives in the wrong direction in some cities, especially older ones. It reduces the attractiveness of new building—to add to the total supply and to replace older structures—without a corresponding reduction in the need for government spending.

A tax on land reduces the price of land. In effect, a new purchaser will pay *less in price* after a land tax has been imposed than he would have paid before. But he will then pay more each year as tax. Government in a meaningful sense has changed the conditions of ownership. Among other things, the change favors the person with less capital, without burdening or making things

harder for the person more amply supplied with capital. A buyer can acquire with smaller outlay of his own resources plus borrowed funds and with lower annual financing charge (interest plus amortization). He must, however, then pay more each year to government. Original financing becomes somewhat less of a problem.

Assuming that no reduction in total revenue is a realistic possibility, can anything be done to alleviate the undesirable tendencies? Yes, at least in theory. A shift of the proportions of property tax could be beneficial. Suppose that the rate on land values were three times the rate on improvements—or other proportions which would not alter the total revenue for the locality.

As a start toward reform of a major tax, one which will continue to play a large role in our society, such shift of emphasis seems highly attractive. The suggestion here is *not* to increase the total revenue from the "two taxes" but to realign the proportions.

On the average, property owners would pay the same amount of tax. But few would be at just the average. Substantially higher rates on land values would induce owners of low-use land to convert to higher-value uses. Meanwhile, the lower tax rates on buildings would encourage replacement of old structures by new ones, as well as net additions. The benefits, I submit, could be highly significant—not revolutionary, not earthshaking, but not insignificant.

Urban Aid, Land Prices, and Taxation

A final point, one of great significance and some urgency! Programs of urban aid which direct funds and resources of any type into particular areas will tend to raise land prices. Under present arrangements, much of the intended benefit will almost inevitably be incorporated into gains for landowners. They are not necessarily, or primarily, the persons for whom the assistance is designed. Experience should alert us. America's expensive farm programs have had the effect predicted by economic analysis but largely ignored in public discussions when policy has been made: Subsidies have been capitalized, to considerable extent, in higher land prices to the benefit of owners of land at the time. Farm operators, present and future, must then pay more for use of land and thus get no benefit from subsidy.

The same sort of thing must be expected in urban aid unless new policies come into effect. Future residents and other users will get very much less advantage than is intended because land prices will rise to absorb the worth of special aid of a localized nature. Cannot something be done now to avoid such frustration of good intentions by the conversion of assistance into higher land prices, i.e., capital gains for landowners? The property tax is not the ideal instrument for dealing with this challenge. Perhaps, however, it can play a part in a more comprehensive effort.

Most of the analysis of property tax problems has, quite naturally, been concentrated on the local level. The making of national policy has tended to give less attention to the broad aspects of this big

tax than the general welfare warrants. Compared with other ways of financing local government, the property tax does have great merit. But it has avoidable defects. Efforts to reduce them are al-

ways desirable. And today, efforts to fit such reform into a broader approach to tax progress seem both urgently needed and perhaps more promising of positive results than ever before.