



A Conversation with Mason Gaffney

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Lower Taxes? RTI — A Quiet Revolution

Henry George — the name has the ring of Americana; the sound of a name which might have been a patriot in the American Revolution. Yet, George followed the revolution by 100 years and the impact of his ideas is being widely felt today.

In this special issue of the Ukropina Report we examine Reduced Taxation on Improvements or RTI. This concept of taxation originally distilled by George over a century ago and subsequently supported by businessmen, economists and politicians, conservative and liberal alike, is taking on a strong new appeal.

In the last year, a major article has appeared in *Fortune* Magazine and three editorials in the *NEW YORK TIMES* reporting on or advocating the virtues of this form of property taxation. Already, various forms of this tax structure have been applied both in the U.S. and abroad with great reports of success. Essentially this taxation method unencumbers improvements by placing greater property tax burden on land value. The claimed results: developers are rewarded, speculators penalized, unimproved or run-down properties gain useful new lives, employment increases and municipal revenues are greatly enhanced.

With increasing media attention, George's legacy may one day come to California. Its possible impact slight or great, should be of concern to all, especially those in the real estate, development and business communities.

—Bill Ukropina
Wm. D. Feldman Assoc.

Population in the U.S. is expected to reach 400 million by the year 2020 — Federal deficits are almost uncontrollably high — municipal revenues are tightly squeezed and the funds needed for the rehabilitation of roads and bridges alone are projected to be at least \$5 trillion dollars. Last summer, at the American Cities Mayor's Conference, it was agreed that the worst single problem facing U.S. cities is uncontrolled hunger and destitution. Also concluded, however, was that no means exists for the cities to solve the problem from their own resources — the funds must come from the Federal government.

In spite of such a grim outlook, advocates of Reduced Taxes on Improvements or RTI, claim the future can be brighter for all — cities, landowners and developers combined. Cities here and abroad, which have placed RTI into effect, are discovering unexpected resources with which to finance the future along with self sustained property and economic development. *Fortune* Magazine (8-8-83) quoted a Pittsburgh Councilman describing the new taxation method, "... like finding a pot of gold in our own backyard ..." This method, reducing property taxes on improvements, while it has recently come to the fore as a hope for the future of our cities is not a new idea. In the past, however, resources were such that there was little need to attempt to achieve maximum efficiency in generating revenues from the real property taxes. Cities in Pennsylvania, Alberta, New Zealand, Australia, South Africa and Taiwan have generated strong revenue growth and property development through this taxation method first explained by Henry George almost a century ago.

RTI proponents explain it this way, land has value as defined by its optimal economic usage. A simplified model of the effect works like this:

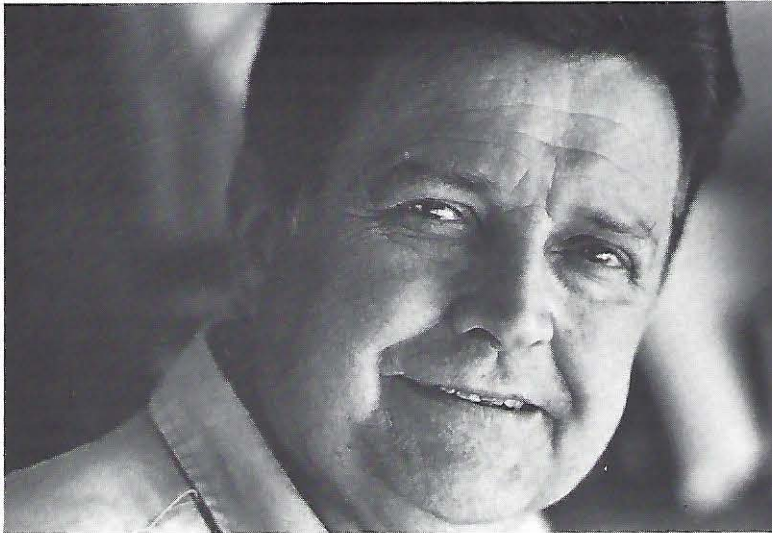
"Imagine that A and B each hold identical plots of land assessed at \$10,000 on which \$100 of taxes are paid. However, A's property has been improved by the construction of a building assessed at \$100,000 on which taxes of \$1,000 are paid. Total revenues for both properties are \$1,200. Now let us assume the voters decide to eliminate taxes on improvements and to shift the tax to the land itself. Both plots of land are now assessed at \$110,000 the value which A's building has demonstrated them to have. Assume that the rate of taxation (1%) remains the same. In this unlikely event, revenues would rise to \$2,200, an increase of 83.3%. But let us assume that the community concludes that a 15% increase in revenues is adequate. They thus desire to produce \$1,380 in revenues from these properties. Since both taxpayers are now paying equal amounts, A's taxes drop to \$690 while B's rise by \$590 or nearly 600%. A has been rewarded by the community for having improved his property, an act which conferred a benefit upon the community in the form of additional jobs and the injection of payroll funds into the stream of local commerce.

"B, on the other hand, must now either find a use for his property which will support the increased tax load or sell it to someone who will. It should be noted however, that if B does decide to improve his property thus conferring a benefit upon society, he is not penalized as under present conditions."

The experiences with RTI throughout the world have been the same — it has worked wherever tried with the same degree of success as the extent to which it is applied. Where taxes on improvements have been totally removed, its success has been greatest and the degree of its success elsewhere has been in direct proportion to the amount taxes on improvements have been reduced when taxes on improvements are not totally removed. In Pittsburgh, the mill rate on land is presently 15.15 and that on improvements 2.75. As a measure of its success the city recently advertised that during the last ten years 167 companies, 85 from abroad, have moved their U.S. headquarters to that city to take advantage of the favorable tax climate. Four other communities in Pennsylvania; McKeesport, Scranton, Harrisburg, New Castle and Hawaii County, as well as over 1000 communities in Australia, New Zealand, Canada, Denmark and Taiwan report experiences similar to those in Pittsburgh.

A conversation with

MASON GAFFNEY



YOUNGBLOOD

Mason Gaffney, Professor of Economics at UC Riverside, specializes in the economic implications of taxation. A proponent of RTI, he has also written extensively on timber, mineral and agricultural taxation; urban development and the economics of water use. A former economist to the Provincial Government of British Columbia, Gaffney received his Doctorate in Economics from UC Berkeley.

Reduced taxation on improvements offers the possibility of reduced per parcel taxes while promoting economic growth and enhanced municipal revenues — how are such paradoxes possible?

As individuals, we all view taxes negatively because they take money away from us and we don't like that. But, if you think about the effects and incentives what's important is whether the tax appears as a fixed cost or a variable cost to the individual. Tax economists describe the occasion for paying taxes as the taxable event. In the case of a tax on land values, instead of improvements, the only taxable event is, the earth going around the sun, once a year the tax is due. It only depends on the value of the land and the value of the land does not depend primarily on what the land owner does, so the tax is exogenous. It is not controlled by the individual — but maybe we could just stick with the fixed cost idea. The tax is part of the fixed cost and not part of the variable cost. Unless, of course, he buys more land, but as far as the individual parcel of land is concerned, it's a fixed cost. In order to meet that fixed cost he's under the gun to improve the land but when he does improve the land there's no increase in the tax.

If I'm correct in my understanding, the current tax structure functions as a fixed and variable tax both since we are taxed for the land at sale value which would be your fixed tax, plus the value of the improvements which is your variable tax.

That's right. And in California the property tax base is divided about equally between land and improvements.

When a reduced taxation on improvements structure is set up — let's take a model and say that it is taxed 50% to improvements and 50% to the value of the real estate, and you switched over to RTI — what happens in that particular moment to a land owner who has a vacant lot that he is speculating on and his neighbor next door who has a commercial structure he uses for business?

The owner with the vacant lot is put under increased pressure to improve that lot. In addition, the value of his lot in the market would probably not be much affected — although his taxes go up on the land the anticipated taxes on the improvement that hasn't been built yet are reduced to zero. Since the land value is determined by capitalizing individual income left over after penciling out the improvements, the net return from the improvement goes way up and that advantage is capitalizing to the land value. So, those two effects offset each other as far as valuation is concerned. There's no big effect on value but there is very great effect on incentives.

In the model situation we've switched from the situation where the speculator benefits to where the developer benefits.

That's correct. It's a double-barrel effect when you consider the effect on credit rating of the two parties, because at present the developer is in a cash squeeze at the time he builds because he is most vulnerable then. He's put out the most money and at that point the tax collector jumps on him. At the same time the non-developer being favored by the tax system is in a better credit position. But when you change the tax system you also change the credit picture so that

"... RTI has the same effect as lowering the tax rate for the person who improves."

Interviewed by Bill Youngblood

now the person that doesn't build has poorer credit because he's got the cash drain of losing frozen taxes that forces him to sell or improve. The person who does build is in a better credit position because he doesn't have to pay increased taxes at the time he builds.

What are some more subtle implications of how RTI promotes development?

It's not really so unfamiliar when you look at the reasoning that went into the Williamson Act. There, the thinking was very much that there were some people who wanted to slow down the conversion of farm land to development. They observed that the pressure of property taxes was the thing that made a lot of land owners sell and it was with that in mind that they pushed through the Williamson Act — in order to keep out land speculators. It is not the way they put it of course but that was the effect. So it's not a strange idea, it's saying in effect that you want to encourage speculators to sell.

What are a few examples of the areas where RTI has been applied, what's the extent of application and how has it worked?

RTI is something that can be applied in whole or in part, on a large scale or a small scale. If you look at it in a comprehensive reform it's never been fully applied. If you look at it as a partial reform there are dozens of instances all over. One such instance is here in California starting with the Wright Act of 1887 which set up assessment districts for financing water supply projects mainly in agriculture. Today we call these irrigation districts. They cover about 4 million acres of farm land in California. Under the original act, there was a local option where the district could, if they wanted to, include buildings for taxation. In 1909 it was made mandatory to exempt buildings and farm improvements. So, since 1909 the irrigation districts have levied exclusively on land value. It had two or three objectives which were pretty well carried out. One — when the district issued bonds and put up a lot of front money to develop the water supply sys-

tem they wanted to make sure that the land owners were under pressure to switch over to irrigation at more or less the same time, so they wouldn't be hanging out to dry paying interest without getting any revenue. So its purpose was to synchronize and accelerate development and it worked very well. The second — to avoid the high cost of running ditches past empty land. They wanted compact service areas and again it succeeded in that. That business of running ditches past empty land is the agricultural equivalent of urban sprawl. You could call it irrigation sprawl. They wanted to avoid irrigation sprawl which would run their costs way up. There are over one-hundred irrigation districts in the state. Some of them are just paper districts, but a lot of them have financed very expensive and impressive projects — they have developed the land in conjunction with the project. It takes both and this financing system has accomplished that. It is a truly remarkable achievement that is very little appreciated by most people. Now, it should be understood that we're just talking about a portion of the large tax structure, these irrigation districts really were superimposed on the existing system of county taxation.

What would happen if you take what we demonstrated with the water district and applied it to California as a whole on residential and commercial property?

It has two effects. One at least. First — it would accelerate the pace of development and the other which is an important adjunct — it would tend to recentralize development. The impact would be felt stronger in the more central areas. And I think that is very important because the major opposition to development today is based on fear of urban sprawl and all that that implies.

So, your downtown areas where you have the greatest urban blight, because currently there's no incentive to improve, would be the areas that would feel the greatest impact of a change.

Certainly at first, and then I think it would roll outward over time but you'd end up serving the given population in a

smaller area. It gets more compact development. Infilling I guess is a good word they use today. Some years ago I did a study in Milwaukee in considerable detail and discovered that if you switch from the present property tax system to an RTI system, an incredibly high percentage of all the land would be renewed almost immediately. It was something like 25%. Twenty-five percent of that land was hanging right at the edge of a cliff of demolition and renewal.

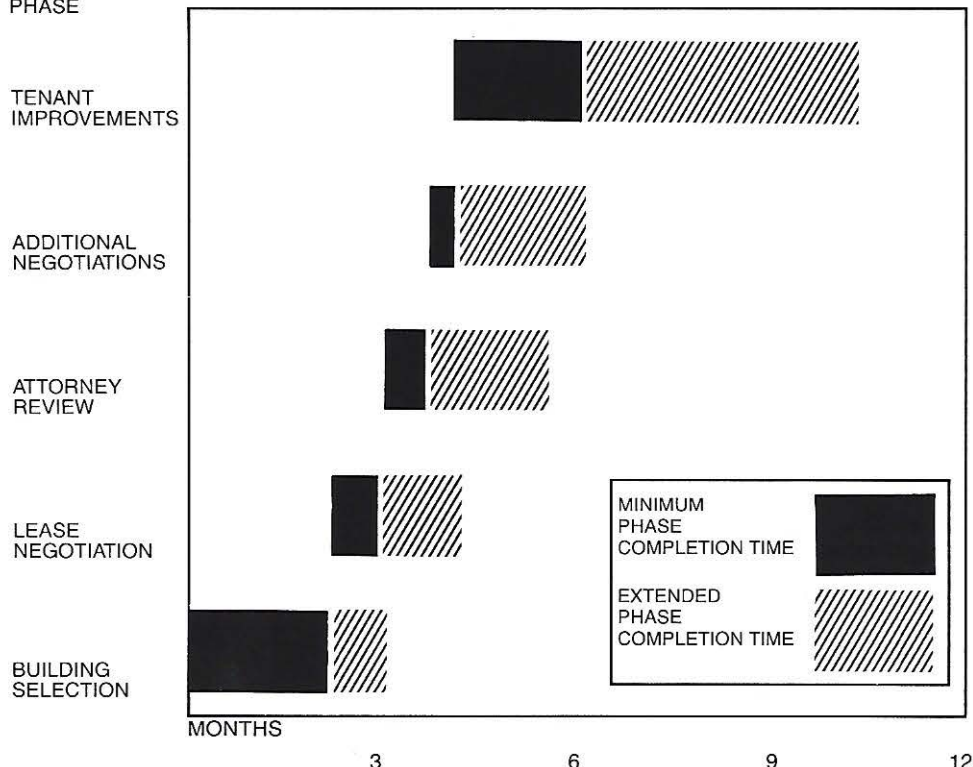
What about municipalities and the implication to their revenues. I understand there are indications that they can actually generate more revenues.

Yes, you'll find some places that depend heavily on one or a few industries for their property tax revenues. We'll find that the industry has a high ratio of building to land value and then they'll be concerned that this may involve a switch to residential property. There are a few cases where that is true. I've looked at a few of those and my strong impression was that the industrial land was being seriously under valued. I think of one specific example which is not untypical — in West Allis, Wisconsin where Allis Chalmers is located. The factory building happens to be right on the hottest corner in town. Three of the corners are commercial and the fourth corner is the edge of the Allis Chalmers factory but because that land has never been subdivided, it's assessed as raw acreage and the assessment on that land is 10% or less than the land across the street. Now, I just call that bad assessment practice which could be corrected. I think that some review of assessment practices is necessary in order to make this thing work out in a case like that.

As an economist how do you appraise the real applications of RTI?

I think it's a very effective tool for development and urban renewal. It can be applied on a small scale in which case you'll get small, finite, and practical results. It could theoretically be applied on a large scale in which you could get some sensational results. It really does for a property tax what accelerated depreciation does for the income tax. Acce-

PHASE



Leasing

Making the Move

Looking for office space is often a long and time consuming process. The greatest success comes to those firms starting their search for new locations early. If a company move is planned and your lease expires within nine to twelve months your location hunt should be well along.

Location is the most critical factor in your mix of decisions. This key element can effect business growth, exposure, accessibility, costs and labor pool. Consider items such as: site visibility, freeway system access, airport proximity, public transportation, business neighbors, nearby residential areas, telephone area code and rates and possibly crime statistics. Area selection can run from one to three months.

Searching for that ideal building begins once the general area has been decided. Touring available buildings thoroughly can be expected to take at least a month with considerable time in the field away from the office.

Negotiations should begin with at least two buildings once the choice has been narrowed. This provides leverage and bargaining power as two or more building owners will better each other's offer when competing for the same tenant. Among the overall rental terms consider: rent, tenant improvement allowances, parking, operating expenses, rental escalations, term of the lease, subleasing rights and any special allowances or requirements. Initial negotiations will take a minimum of 30 days to decide on one particular building.

After the lease is negotiated in principal, it is imperative that both parties sign a written letter agreeing on the terms and conditions of the transaction. This will help prevent any disputes before the lease is drawn. Counsel review is the next step to protect against any hidden clauses or ambiguous wording which would prove costly at a later date.

Once the lease is signed, your schedule will revolve around improvement and moving time requirements. Improvement requirements and deadlines should be carefully specified in the lease so that the present lease doesn't expire before the new space is ready for occupancy. Space preparation and moving are big variables in a relocation timetable and should be allowed for according to the level of improvements required and the current condition of the new space. Allowing at least two months after lease signing before move-in is a good rule of thumb.

To expedite the search process most firms choose to work with one particular industrial or commercial real estate broker as their representative. This provides for consistent hunt and negotiation strategy as different buildings are compared. Ultimately this consistency will benefit the firm in time savings and the most favorable leasing agreement.

RTI ...

Continued from page 1

The great drawback of the present method is that it harnesses the profit motive in reverse, rewarding him who does least, penalizing him who does most to generate economic growth and employment. Speculators win while developers have to carry tax burdens. In New York City this fact is being made clear. Three times in the last year the NEW YORK TIMES has employed its editorial pages to urge the legislature of New York State to enact the legislation necessary to permit New York City to tax improvements at a lower rate than real property. The TIMES had this to say in their most recent comment on the topic: "The best way to encourage useful development is to reduce the tax rate on all improvements, while correspondingly raising the taxes on their locational values — land."

GAFFNEY ...

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lated depreciation encourages investment in new capital. It gives you an advantage when you improve — it doesn't give you an advantage when you don't improve, and since land is not depreciable the benefit of accelerated depreciation goes entirely to the person who improves property. It has the same effect as lowering the tax rate for the person who improves. That's the same idea that RTI has to apply through the property tax instead of through the income tax.

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