



Two Alternative Property Tax Systems in a Metropolitan County: Economic and Land Use Impacts

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Emphasis by Wm. Tabb.

"TWO ALTERNATIVE PROPERTY TAX SYSTEMS IN A METROPOLITAN
COUNTY: ECONOMIC AND LAND USE IMPACTS"

By M. Mason Gaffney

Preliminary detailed outline for discussion at ULI Research Committee -
Technical Advisory Panel Research Planning Conference, Washington, D.C.,
February 28, 1963.

I. The two modes of property taxation which will be contrasted:

A. THE GENERAL PROPERTY TAX AS CURRENTLY ADMINISTERED IN
MILWAUKEE COUNTY, WISCONSIN.

1. The local system in a vacuum

a. Background data (the jurisdictions; revenues and
expenses; general property tax revenues; area; population; etc.)
Readily available from published sources, and unpublished Harold Groves MS.

b. The tax base, de jure and de facto. Assessment discrimi-
nation. Recently studied by a Metropolitan Study Commission under
Robert E. Jensen of American Appraisal Company. Miscellaneous materials
available from other sources, the topic having been much agitated in
recent years. Unfortunately, neither the Jensen study nor others yet
examined give explicit attention to the type of discrimination most
relevant to this study, between land and structures. Ascertain sketchily
from such primary data as can be gathered in the limited time available,
and from the 1957 Census of Governments study.

Primary data most relevant, inasmuch as basic concept of land
value proposed in this study (highest and best use), differs, particularly
where the land is under an old building, from concepts often applied in
published studies. Approach the question by observing the assessor's
reaction to zoning changes: does he change the land assessment immediately,
in keeping with the new income possibilities, or does he wait until the
actual use is changed? Similarly with new highways, etc.,

c. Subdivision in the assessment process

d. Plottage in the assessment process

e. Incidental to the above investigation, try to explicate
the motives of the local powers in adopting one or another pattern of
discrimination. This is preliminary to headings III and IV.

Are the motives of the local powers in harmony with the broader
public interest? If not, is the conflict reconciled by equalization, or
by State and Federal finance?

2. The system as modified by interaction with State and
Federal taxes and subventions.

a. State. Primarily of interest as an explainer and
modifier of local motivations, rather than of individual motivations.

De-emphasize aspects of parochial Wisconsin interest.

1. Utility assessment and rebate.
2. Subventions: income tax rebate; school attendance rebate; others.
3. State income tax
4. Death duties

b. Federal (personal and corporate income tax; death duties)

Income tax a major influence modifying impact of local taxes on incentives of individuals

1. Deductibility of local property taxes
 2. The quest for capital gains treatment
 3. Avoidance of capital gains tax: prospect of lower future rates; avoidance through death; avoidance through gift and bequest; avoidance through non-sale; etc.
 4. Depreciation. The quest to depreciate land. A cause for understatement of the land component in real estate?
 5. Deductibility of interest. Effect on credit rationing and the problem of differential capitalization rates
3. The system under a spectrum of rates

Jurisdictions ranked by effective rates: on real estate; on land; on structures. The last two will be undertaken only to the extent that the information can be ascertained or estimated. If there are significant contrasts in the treatment of land and buildings, and they have persisted over a reasonable time (say ten years,) and the jurisdictions are reasonably comparable in other ways, compare land uses between jurisdictions. This is an option.

B. PROPOSED TAX ON BARE SITE VALUES

1. Legal constraints. Latitude of assessors. Latitude of Legislature. Amending Constitution.
2. Select terminology to maximize clarity and facilitate analysis. There is an "omelette school" which holds we cannot unscramble inputs. Problem here is more analogous to distinguishing the omelette from the frying pan.

Conventional marginal analysis and distribution theory taken as basis for imputing separate values to separate inputs. Develop concept of marginal net product of land. Develop it spatially and temporally. It is generally more usable than residual approach, but consistent with it.

The concept of "public value of land," used by Marshall, Edgeworth, and Pigou. Obviates debate about human contribution to value. Land value not represented as entirely a "natural" product, but as that plus a public product. Public contribution comes from both government works and external

economies spilling over from other private activities. Both the natural and the public elements are regarded as derived from the public. Together they create in the land a capacity or latent potentiality to yield private income, which capacity exists independent of the actual response to it made by the atomistic individual landholder.

It is useful to distinguish the "development" of lands by providing basic social overhead capital; and the "improvement" of individual lots or sites by atomistic private occupants. "Development" generally comprehends provision of the "intersite sector" of transportation and distributive networks for utilities, but it also includes other basic public facilities. Note that the "improvement" of each private parcel contributes something to the "development" of neighboring lands, due to external economies, both technological and pecuniary. (Sometimes, of course, the net external effects are negative.)

Special problems in distinguishing public value from privately created values: when public facilities are congested (short-run increasing costs); when the line between private and public is blurred; when the public service is contingent on occupancy; when the landholding is too large to treat as "atomistic."

3. Separating land value from value of old buildings.

Conventional marginal analysis inadequate, lacks a time dimension.

Difficulties seen by several authorities: Wenzlick; Ratcliffe; Ely; Wendt; various agricultural land economists.

Recommended method. The site has at any time a prospective future use, hence a definite opportunity cost. The site may be withdrawn from the site-building package by demolition of the building. It is not necessary actually to demolish the building, only to contemplate doing so. The value of the building itself is the residual, subtracting site opportunity cost from the joint value of land and building. Adoption of this straightforward method of separation is hindered by the classical tradition of approaching land value as a residual. The method still permits (but does not require) determining land value as a residual, in the contemplation of the best future use.

This building-residual method entails the common sense corollary that the time to demolish an old building is when its emplaced value falls to zero. That concept is used later in the outline.

The building-residual method might be used in conjunction with the market approach to appraisal (Wendt); or the discounted future income approach (Babcock). It could even be made consistent with the replacement-less-depreciation approach, but with so much strain that it hardly seems worth the effort.

Structures other than buildings: extend the same principle.

Problems of remodeling and other piecemeal demolition and renewal: explicate necessary modifications of basic principle.

Renewal gap = 0

The problem of grandfather clauses, granting privileged status to old buildings to violate codes. Is the privilege value part of land value, building value, or something else?

The acceleration of renewal which would ensue upon shifting taxes from buildings to land values would tend to ease the problem of land appraisal by increasing the market evidence on which appraisals may be based.

4. Alternative forms of the land tax base: capacity basis vs. use basis; yearly basis vs. capitalized basis; ordinary income vs. capital gain basis.

a. Capacity vs. use. The use basis, or kinetic income basis, whether gross or net, contravenes the essential genius of a tax on potential income or capacity. "Land taxes" around the world are often written of as though of a piece; and some welfare economists write of "taxes on economic rent" as being ideal, without specifying either the base or the mode of levy (Pigou's "announcement effect.") Actually, a "land tax" can destroy incentives, if contingent on use; and non-land taxes can enhance incentives, if levied on capacities rather than performances. The significance of land is that it constitutes the most feasible base for a tax levied on capacity rather than performance. Land-capacity is susceptible of appraisal; and to tax it does not violate canons of distributive equity, as would a poll tax, human faculty tax, or other conceivable tax of neutral announcement effect.

"Neutrality", however, is a misleading term which presupposes some prototypic norm in the absence of taxes, an unrealistic concept. Taxes levied on capacity, regardless of activity or utilization, are more than "neutral" if contrasted to a hypothetical situation in which there are no taxes, but the same public services. Taxes on capacity apply leverage, like any fixed charge. This is in addition to what public finance people call "income effect," (and probably should call "asset effect"). It is the same kind of leverage that bondholders apply to stockholders, regardless of the stockholders' other income or assets.

Neutrality in taxation is therefore hardly a realistic concept. The basic issue is between fiscal leverage and fiscal profit-sharing. The former fortifies productive incentives; the latter dilutes them.

It may be that fiscal profit-sharing encourages some kinds of risk-taking. However, fiscal leverage encourages some kinds, too, by prodding conservative landholders into riskier enterprises where those tend to yield higher mean annual net incomes over time. This issue warrants further explication. In general it is my position that risk-taking is not inherently good, and that risks which are undertaken only because shared with the fisc are inherently uneconomical.

b. Yearly basis vs. capitalized basis. Both capacity appraisals and performance appraisals could be either yearly or capitalized.

Generally, capitalized basis is better because use plans extend over many years, from initial building to ultimate demolition, with variable yearly income. Indeed, capitalization looks beyond one cycle to a long series of future cycles of investment and liquidation. *good*

It is proper to regard the income imputed to land as a steady, or at least a smooth, yearly figure, with irregularities and surprises being imputed to other inputs. That is because of the method outlined above for distinguishing land value from building value, with land being valued on

the basis of future opportunity cost, and the building as a residual. The yearly value of land is determined by annualizing expected future net revenues, which, even in anticipation, are to be irregular. This concept will be developed and elaborated.

The problem of higher future use -- will the current tax then be too high? Problem needs analysis. Involves a good deal more than the restricted assumptions implicit in Ely's ripening cost doctrine. Best use over time entails prolonging old use in preference to idling land, or starting a bob-tailed cycle of investment and liquidation during a brief waiting period. There is also the question of how tax policy itself affects the widespread uncertainty that is implied in the ripening costs concept. A tax policy that promotes quick and full response of landholders to new demand stimuli will tend to satisfy demand within a smaller area than now, when the "floating value" hovers over more land than demand can absorb within a reasonable time.

c. Capital gains base. A tax on "unearned increment." Not the idea at all. Avoidable by non-sale, tends to withdraw land from commerce and delay its movement to highest use.

5. Definition of the tax base when parcels of wrong size or shape.

Plottage. Ideally, appraisal should include plottage, thus induce optimal recombinations, both assembly and subdivision. Plottage taxation is useful to weaken holdouts from assembly, obviating use of eminent domain; also to induce subdivision of large old estates, etc., where highest and best use involves smaller parcels. Those communities which enforce large-lot zoning would probably not be interested in such taxation, unless the feared external costs of small lots are offset in some other way.

It should be emphasized that plottage taxation is not a plot against either the rich or the poor -- it will be accused of both -- but an objective effort to nudge land towards its best use.

Plottage taxation is an explosive topic. If we were discussing political strategy, we might defer it, but the possibilities for economic analysis are the major interest here, and out of all the applications considered, some will be politically feasible.

How far might plottage taxation be carried? In weakening holdouts from assemblies, key holdouts might be assessed more than their pro rata share of the value in a large assembly, but their marginal value, in this case their nuisance value or what-the-traffic-will bear value.

That principle need not be limited to a few large assemblies. It can be quite general. Distinguish marginal rent from average rent (see second par. of B,2, above). When optimal size of all lots rises, as would occur from cheaper transportation, and has occurred in most cities, the marginal rent exceeds the average, as each lot is too small. (In the current farm land market, that phenomenon has resulted in a whole level of land values, appraisals, and assessments, based on demand for land for expansion, with marginal values higher than average ones.) Such plottage taxation tends to hasten the recombination of units dictated by new economic needs.

6. Definition of the tax base in respect to mutual interdependencies.

*realistic?
unfair
burden?*

The capacity of an individual lot is limited by its environs. External diseconomies spilling over from blighted neighboring lots limit the renewal possibilities of any lot. Synchronized renewal could lift an entire district to a distinctly higher level of use. Such synchronization is achievable by designating renewal districts, and taxing the lots on the basis of the renewal of the whole area. There would be protests, but the landholders should be better off if the whole level of values rises.

Whitefish Bay

There was a time when such a measure might be dismissed out of hand as involving too much government. Today it is to be regarded as an alternative to public housing, subsidized and directed urban renewal, etc., than which it is more consistent with free enterprise. It is also easier on the U. S. Treasury.

So far as economic principles are involved, the above principle could be extended quite far. For example, a State, upon extending trunkline highway service to new lands, might assess landholders on the assumption that they would organize as a local government to improve their opportunities by supplying themselves with a feeder network of local streets, etc. Fantastic? The failure of municipalities to match State and Federal works with local works is as great a factor in urban sprawl as is the failure of individual landholders to match local works with private improvements. It would be of questionable value to solve the problem in the small, and leave it rampant in the large.

NOTE: The Panel's counsel is solicited as to the wisdom of pursuing this optional aspect of the study.

7. The tax base in respect to enhancement by the private owner.

The private owner is part of the "public" that contributes to the "public value" of land. Usually his influence is negligible -- that is the implication of "atomistic." Sometimes his influence is appreciable, especially if his holding is large. Then he participates in planning and financing the "intersite sector" of utilities and transportation, and the external economies from one improvement spill over to affect the value of other lands that he owns.

Ideal solution is to tax sites that are susceptible of large, integrated development on that basis. The essential principle is to tax not the fait accompli, but the fait praticable. It will be protested that such taxation would force all land into the hands of large developers, but in fact it may be an effective substitute for large scale development by inducing the coordination and synchronization of mutually interdependent small parcel improvements as outlined in Section 6, just above.

Subdivision should not increase the tax yield of a given acreage by more than actual costs of subdividing. Current practice in this respect constitutes a deterrent to subdivision. Again, tax fait praticable, not fait accompli.

8. Listing of some other problems in defining the tax base.

- a. Truly permanent improvements - how to unscramble from land?
- b. Tax capitalization.

c. Zoning taxation. Zoning is a major influence on site capacity, and site capacity taxation is in part the taxation of favorable zoning. This may appear to be complicated by overzoning, but it is in some measure the solution to overzoning. Only those will seek commercial zoning who are really ready to exploit it. Zoning will cease to be the subject of aldermanic logrolling. The commercial zonee receives a privilege from the community, and he pays a price for it, an annual tax. Zoning is merely permissive, but the yearly tax constitutes the economic equivalent of a mandatory injunction to improve the opportunities presented by the zoning classification.

d. Possible modifications of the tax base to account for external economies and demands on public services.

Zoning is a crude instrument. Taxation has an incremental quality lacking in zoning, with its small number of classes. Taxation can supplement the zoning power.

If we desire to reduce lot coverage and height, because of external effects, it would be more effective to tax them directly than to tax buildings ad valorem, which is also to tax quality and newness.

Often it is desired to tax persons. That may be done by putting a heavier tax on higher density zoning, thus limiting the numbers who apply for such zoning. The rationale of taxing persons is that there are common public facilities which those with small private lots use as much as, and probably more than, those with large private lots. The wisdom of proceeding on this line depends on the congestion of public facilities, not just as they are but as they might be. We cannot assume that all public facilities are in the stage of increasing costs, particularly long run increasing costs. James B. Conant tells us most of our public schools should be large, for example.

As to streets, that is a matter less of persons than of cars, and would better be handled by taxing cars (by their space-consumption) directly. As to utility networks, and public transportation, they are almost always in the stage of decreasing costs (long run). Taxation designed to reduce density, therefore, is of limited desirability. Where it is desirable, however, it is accomplishable without taxing buildings.

The worst sort of overcrowding is not that brought on by new apartments, but by old slums. It does not make sense, therefore, to tax new buildings to reduce crowding.

II. CONTRASTING IMPACTS OF THE TWO MODES OF PROPERTY TAXATION ON LAND USE.

A. A priori

Shift from general property base to land-capacity base has its impact by changing the costs (to the individual) of holding land, and the costs of improving land.

1. Costs of holding land.

a. Substitutes explicit charge for implicit cost.

Applies leverage.

The explicit charge, the tax, is in rem; implicit charge, imputed interest on price of title, is in personam, depends on credit rating. So the two charges bear differently on different individuals, and the shift to land basis causes some reallocation.

b. Increases yearly cost.

Although land tax is capitalized, simultaneous removal of building tax offsets it. So land value remains roughly constant, while tax rate on land rises.

Higher yearly land cost means closer economy of land, at both spatial and temporal margins. That tends toward higher intensity, and earlier renewal.

2. Costs of improving land.

Fiscal burden on building is removed. Induces more capital per lot: more initial value; earlier renewal.

3. Expected increments to land price.

These conduce to poor land use by offsetting costs of holding title without benefit of any ordinary income.

Higher land tax dilutes their relative weight - gives them more cost to offset. Also may lower them absolutely.

B. Impacts on land use.

1. General principles.

a. Lot coverage.

Needs further study. Certainly untaxing buildings tends to put more capital into buildings. But that may take the form of higher quality, more than higher coverage; and the higher quality may call for more land per building (moot point!).

b. Quality

Increases. In a given community, however, open to immigration, the in rem qualities of land taxation may give it a selective appeal to lower middle-class buyers of indifferent credit ratings, thus bring in a stratum of the population which, while not the lowest, is only average in income and total assets.

c. Frequency of replacement.

Accelerates.

1. Land-time costlier
2. Renewal cheaper

A 2% tax on building value, continued over 50 years, is the equivalent of a 36% sales tax on the new building (at 5% interest). The opportunity cost of the land under old buildings, based on the best future alternative, is correspondingly reduced. Thus renewal is deferred. Renewal only comes when the bare site outvalues the old building and site together.

As it happens, this fiscal deadweight on the value of land for renewal is greater than the "renewal gap" - the excess of old building and land value over bare land value - that obtains over wide areas, and for long periods.

It is proposed to gather data on renewal gaps from study of the renewal program of Whitefish Bay, Wisconsin. This village absorbs a demolition loss on old buildings of some \$5,000, and compensates itself from the increased tax revenues from the new building. The result approximates that which should follow from exempting buildings, and will be used to illustrate one of the likely consequences of the policy.

d. Population density

Untaxing buildings increases aggregate supply and quality of floor space, and so must reduce over-all density per foot of floor space. As to density per acre, that depends on outcome of (a) above (see preceding page). |?

e. Traffic density

f. Slum and blight prevention

g. Encouragement of privately-financed urban renewal and rehabilitation.

h. Effects on market value of real estate.

(Items (e) through (h) already alluded to in foregoing text)

III. ADEQUACY OF THE TAX BASES.

A. Effects on factor proportions.

This is regarded as the most interesting new area in the study, ^{wow!} with implications for economic development and growth, and macro-economic employment theory as well.

A shift to the land tax base should tend to increase the labor component in the mix of construction inputs, over time, by increasing the frequency of renewal. Labor is applied primarily at the time of building. If the product of labor is carried over 100 years, then interest and land charges mount much higher, relative to initial cost, than if you carry it over 25 years. Again, in the 25 year cycle, you apply construction labor to 4% of your sites yearly; in the 100 year cycle, to 1%.

That which accelerates renewal, therefore, also increases the proportion of the labor input in the provision of housing services, and indeed, all durable capital services. In a time of short capital, dear land, and unemployed labor, that seems a desirable change.

The problem may be, though, that attracting people to a local jurisdiction poses a threat of increased local service costs, that increase out of proportion to the tax base. That is the problem with which this section must wrestle. It is a key question, because in the absence of such concerns the case for exempting buildings is so compelling as to leave us wondering why it has not been done for centuries.

* * * * *

POSTSCRIPT.

The above notes do not comprehend the full study outline, and must be shortened to meet our deadline. They should, however, give us an adequate basis for a one-day discussion, and they do set forth the main lines of thought for the proposed study.

M.M.G.